Supreme Court, U.S.
FILED
041371 APR 11 2005
OFFICE OF THE CLERK

No. 04-

IN THE

# Supreme Court of the United States

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

*Petitioner*,

*v.*

SHADI DABIT, on behalf of himself and all others similarly situated,

*Respondents.*

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

## PETITION FOR A WRIT OF CERTIORARI

JAY B. KASNER
*Counsel of Record*
EDWARD J. YODOWITZ
SCOTT D. MUSOFF
JOANNE GABORIAULT
SKADDEN, ARPS, SLATE,
MEAGHER & FLOM LLP
Four Times Square
New York, New York 10036
(212) 735-3000

*Counsel for Petitioner*

*Of Counsel*:
PREETA D. BANSAL

193791

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

## QUESTION PRESENTED

Through passage of the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 ("SLUSA"), Congress, *inter alia*, amended Section 28 of the Securities Exchange Act of 1934 to preempt any private action brought on behalf of 50 or more persons from proceeding under the statutory or common law of any State in any state or federal court if such action alleges "[a] misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1)(A), (5)(B).

In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), this Court adopted a "purchaser-seller" standing limitation in private actions brought under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), by requiring the private plaintiff to be an actual purchaser or seller. The decision below implicates whether that judicially crafted "purchaser-seller" standing requirement articulated as a limit on private fraud actions under Section 10(b) applies to limit SLUSA's broad preemptive scope over state law claims.

The question presented in this petition is:

Whether, as the Seventh Circuit held earlier this month and in direct conflict with the decision below, SLUSA preempts state law class action claims based upon allegedly fraudulent statements or omissions brought solely on behalf of persons who were induced thereby to hold or retain (and not purchase or sell) securities?

## STATEMENT PURSUANT TO RULE 29.6

Petitioner Merrill Lynch, Pierce, Fenner & Smith Incorporated is wholly owned by Merrill Lynch & Co., Inc. Merrill Lynch & Co., Inc. is a publicly held company whose shares are traded on the New York Stock Exchange.

## TABLE OF CONTENTS


| | Page |
|---|---|
| QUESTION PRESENTED | i |
| STATEMENT PURSUANT TO RULE 29.6 | ii |
| TABLE OF CONTENTS | iii |
| TABLE OF CITED AUTHORITIES | v |
| TABLE OF APPENDICES | ix |
| OPINIONS BELOW | 1 |
| STATEMENT OF JURISDICTION | 1 |
| STATUTORY PROVISIONS INVOLVED | 1 |
| STATEMENT | 2 |
| A. Introduction | 2 |
| B. Proceedings Below | 6 |
| C. The Decision Below | 8 |
| REASONS FOR GRANTING THE PETITION | 11 |
| A. There is a Direct and Deep Conflict Among the Circuits Concerning the Question Presented in this Case. | 11 |

*Contents*

*Page*

B. The Second Circuit's Interpretation of SLUSA is Wrong on a Crucial Issue of Federal Statutory Law and Its Holding Will Eviscerate the Purpose of the Statute. ..... 13

1. The Second Circuit's Reasoning Is Contrary to the Plain Language of the Statute and Is Flawed. ..... 13

2. The Second Circuit's Decision Will Undermine the Express Purpose of the Statute. ..... 16

C. This Case Presents a Unique and Necessary Opportunity to Resolve the Circuit Conflict and Restore the Intent of SLUSA. ..... 19

CONCLUSION ..... 22

## TABLE OF CITED AUTHORITIES

*Page*

### CASES

*Abada v. Charles Schwab & Co.*, 300 F.3d 1112 (9th Cir. 2002) ..... 12, 17

*Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) .....*passim*

*Caminetti v. United States*, 242 U.S. 470 (1917) ... 14

*Dabit v. Merrill Lynch & Co., Inc.*, 395 F.3d 25 (2d Cir. 2005) .....*passim*

*Green v. Ameritrade, Inc.*, 279 F.3d 590 (8th Cir. 2002) ..... 12

*Holmes v. SIPC*, 503 U.S. 258 (1992) ..... 14

*Kircher v. Putnam Funds Trust*, 2005 U.S. App. LEXIS 5372 (7th Cir. Apr. 5, 2005) .....*passim*

*Lander v. Hartford Life & Annuity Insurance Co.*, 251 F.3d 101 (2d Cir. 2001) ..... 4

*Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005) ..... 21

*Ontario Public Service Employees Union Pension Trust Fund v. Nortel Networks Corp.*, 369 F.3d 27 (2d Cir. 2004), *cert. denied*, 125 S. Ct. 919 (2005) ..... 14

*Cited Authorities*

*Page*

*Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334 (11th Cir.) *cert. denied*, 537 U.S. 950 (2002) ..... 12, 17

*Rowinski v. Salomon Smith Barney Inc.*, 398 F.3d 294 (3d Cir. 2005) ..... 12

*SEC v. Zandford*, 535 U.S. 813 (2002) ..... 14

*Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 332 F.3d 116 (2d Cir. 2003) ..... 12, 17

*Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971) .....14-15

*United States v. O'Hagan*, 521 U.S. 642 (1997) ... 14

*United States v. Naftalin*, 441 U.S. 768 (1979) .... 14

*United States v. Ron Pair Enterprises*, 489 U.S. 235 (1989) ..... 14

*Williams v. AFC Enterprises, Inc.*, 389 F.3d 1185 (11th Cir. 2004) ..... 12, 17

*Cited Authorities*

*Page*

**STATUTES**

Securities Act of 1933, 15 U.S.C. § 77a *et seq.* .... 1

Securities Exchange Act of 1934,
15 U.S.C. § 78a *et seq.* ..... 1

15 U.S.C. § 78j(b) .....*passim*

Private Securities Litigation Reform Act of 1995,
Pub. L. 104-67, 109 Stat. 737 codified in part at
15 U.S.C. §§ 77z-1, 78u-4 ..... 4, 16, 19, 21

Securities Litigation Uniform Standards Act of 1998,
Pub. L. No. 105-353, 112 Stat. 3227 ("SLUSA")
.....*passim*

15 U.S.C. § 77p(b) .....*passim*

15 U.S.C. § 77p(c) ..... 3

15 U.S.C. § 78bb(f)(1) .....*passim*

15 U.S.C. § 78bb(f)(2) ..... 3

28 U.S.C. § 1254(1) ..... 1

**REGULATIONS**

17 C.F.R. § 240.10b-5 ..... 1, 7, 8, 14, 15

*Page*

**OTHER AUTHORITIES**

H.R. Conf. Rep. No. 104-369 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730 ..... 16, 21

S. Rep. No. 105-182 (1998), *available at* 1998 WL 226714 ..... 11, 16

## TABLE OF APPENDICES

*Page*

Appendix A — Opinion Of The United States Court Of Appeals For The Second Circuit Decided January 11, 2005 ..... 1a

Appendix B — Opinion And Decision Of The United States District Court For The Southern District Of New York Dated April 10, 2003 ..... 53a

Appendix C — Relevant Statutes And Regulations ..... 56a

Appendix D – Brief Of The Securities And Exchange Commission Dated June, 2004 ..... 72a

Petitioner respectfully prays that a writ of *certiorari* issue to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

## OPINIONS BELOW

The order of the district court (Pollack, J.) granting petitioner's motion to dismiss the first amended complaint with prejudice is reported at 2003 U.S. Dist. LEXIS 5999 (S.D.N.Y. Apr. 10, 2003) and is reprinted in the Appendix ("Pet. App.") at 53a-55a. The Second Circuit opinion (Sotomayor, J., joined by Oakes and Wesley, JJ.), affirming in part, reversing in part and vacating in part Judge Pollack's order is published at 395 F.3d 25 (2d Cir. 2005) and reprinted at Pet. App. 1a-52a.

## STATEMENT OF JURISDICTION

The court of appeals entered its opinion and order on January 11, 2005. This Court has jurisdiction under 28 U.S.C. § 1254(1).

## STATUTORY PROVISIONS INVOLVED

The pertinent provisions of the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 ("SLUSA"), amending the Securities Act of 1933, (15 U.S.C. § 77a *et seq.*), are codified at 15 U.S.C. § 77p, and the pertinent provisions amending the Securities Exchange Act of 1934, (15 U.S.C. § 78a *et seq.*), are codified at 15 U.S.C. § 78bb(f). These provisions are reproduced at Pet. App. 56a-69a. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (2004), are reproduced at Pet. App. 70a-71a.

In pertinent part, Section 28 of the Securities Exchange Act of 1934, as amended by SLUSA, provides:

> (1) *Class Action Limitations*. No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—
>
> > (A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or
> >
> > (B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

15 U.S.C. § 78bb(f)(1) (Pet. App. 64a).

## STATEMENT

### A. *Introduction*

This case involves the interpretation of the Securities Litigation Uniform Standards Act of 1998. SLUSA mandates that class action litigation involving nationally-traded securities proceed only under the federal securities laws. Thus, SLUSA completely preempts

> covered class action[s] based upon the statutory or common law of any State or subdivision thereof

> . . . by any private party alleging: (A) a misrepresentation or omission of a material fact *in connection with the purchase or sale* of a covered security; or (B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

15 U.S.C. § 78bb(f)(1) (Pet. App. 64a) (emphasis added) *accord* 15 U.S.C. § 77p(b) (Pet. App. 56a).[1] SLUSA's preemptive effect applies whether the state law claims are brought in federal or state court.

SLUSA was passed in an effort to displace divergent state laws and, thereby, to create a uniform, national standard of liability for conduct involving nationally traded securities.

> Some critics of establishing a uniform standard of liability have attacked such legislation as being an affront on Federalism and contrary to the recent trend towards reinforcing state rights. Proponents of the legislation have argued that we live in an information age in which we have truly national, if not international, securities markets and that uniform standards are entirely consistent with Congress's preeminent power over the regulation of interstate and foreign commerce. The Committee, while sensitive to both these considerations, found the interest in promoting

---

1. SLUSA provides that any covered class action meeting the criteria for preemption "shall be removable to the Federal district court for the district in which the action is pending." 15 U.S.C. §§ 77p(c), 78bb(f)(2) (Pet. App. 56a-57a, 63a).

> efficient national markets to be the more convincing and compelling consideration in this context.

S. Rep. No. 105-182 at 4 (1998), *available at* 1998 WL 226714, at *4 (footnote omitted); *see also Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 107-08 (2d Cir. 2001) (SLUSA was "intended to promote uniformity in the securities markets" and prevent "strike suits"). Consistent with this goal, Congress sought to prevent what became known as a "federal flight" by class action plaintiffs seeking to avoid the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995,[2] by filing such claims in state courts. (Pet. App. 13a.)

The Second Circuit, in the decision below, erroneously created a non-statutory exception to SLUSA's complete preemption by holding that the judicially crafted purchaser-seller standing limitation for private securities fraud actions adopted by this Court in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, should be read into the construction of SLUSA's "in connection with" requirement. (Pet. App. 52a.) Under the Second Circuit's interpretation of SLUSA, plaintiffs may maintain – under state law theories and in state courts – class action claims alleging that defendants made misstatements or omissions in connection with the purchase or sale of securities, provided that the putative class purports to exclude any person who actually traded in the subject securities during the putative class period.

In direct contrast, Judge Easterbrook, writing for the Seventh Circuit last week, held that the "in connection with

---

2. Pub. L. No. 104-67, 109 Stat. 737 (codified in part at 15 U.S.C. §§ 77z-1, 78u-4).

the purchase or sale" language in SLUSA is "as broad as § 10(b) itself" and is not affected by "limitations on private rights of action to enforce § 10(b)," such as the purchaser-seller requirement rule adopted by the Court in *Blue Chip Stamps*. *See Kircher v. Putnam Funds Trust*, 2005 U.S. App. LEXIS 5372, at *15 (7th Cir. Apr. 5, 2005). Indeed, Judge Easterbrook recognized that the very claims that the Second Circuit permitted to proceed as state law claims were precisely those that Congress intended to preempt:

> It would be more than a little strange if the Supreme Court's decision [in *Blue Chip Stamps*] to block private litigation by non-traders became the opening by which that very litigation could be pursued under state law, despite the judgment of Congress (reflected in SLUSA) that securities class actions must proceed under federal securities law or not at all.

*Id.* at *13. Under the Seventh Circuit's interpretation of SLUSA, the identical class action that would not be preempted in the Second Circuit must be dismissed as preempted in the Seventh Circuit. *See id.* at *10-15.[3]

This Court should grant review to resolve this direct, acknowledged conflict.

---

3. As Judge Easterbrook noted and as discussed more fully below, the view of the Seventh Circuit is also in conflict with the decisions of the Eighth and Eleventh Circuits. The Third Circuit, by contrast, appears to support the view of the Seventh Circuit. *See Kircher*, 2005 U.S. App. LEXIS 5372, at *10-11.

**B.** ***Proceedings Below***

In the wake of allegations by the New York Attorney General that Petitioner Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") had issued research reports with respect to a number of publicly traded securities that were allegedly biased and not "objective," more than 160 federal securities actions were commenced in no less than 20 federal courts. On April 26, 2002, Respondent Shadi Dabit, a former Merrill Lynch broker, brought a putative class action in the federal district court for the Western District of Oklahoma seeking to represent present and former brokers of Merrill Lynch. Respondent purported to assert claims under state law for breaches of fiduciary duty and the covenant of good faith and fair dealing based on the same allegations that formed the basis of the federal securities actions. Among other things, Respondent pled that various acts and practices, which he described as "hallmarks of stock manipulation," allegedly caused the putative class harm as a result of their "owning and holding" some forty-eight different, nationally traded stocks.

The Oklahoma district court dismissed Respondent's first complaint as preempted by SLUSA and, thereafter, Respondent filed a virtually identical amended complaint that simply eliminated all references to stock purchases; the complaint continued to seek damages "as a result of owning and holding" the same forty-eight stocks. Respondent's case was transferred by the Judicial Panel for Multidistrict Litigation to the late Honorable Milton Pollack, Senior United States District Judge for the Southern District of New York.

On April 10, 2003, Judge Pollack dismissed four complaints – including Respondent's amended complaint – as preempted by SLUSA. (Pet. App. 53a-55a.) Judge Pollack held that

Respondent's state law class action claims were preempted because the claims were "based on the very same alleged series of transactions and occurrences asserted in the federal securities actions currently being coordinated before this Court." (Pet. App. 55a.) Respondent appealed to the United States Court of Appeals for the Second Circuit.

Following oral argument, on March 22, 2004, the Second Circuit requested the views of the United States Securities and Exchange Commission ("SEC") in connection with the resolution of Respondent's appeal. Among other things, the court inquired of the SEC:

a. Whether, in requiring that a preempted action allege wrongdoing "in connection with the purchase or sale" of covered securities under SLUSA, Congress intended the "in connection with" requirement to have the same meaning as the identical term used in the antifraud provision in Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. 78j(b)?

b. "Whether the purchaser-seller rule of standing . . . enunciated in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), should be adopted for SLUSA?"

c. "Whether SLUSA preempts actions that could not have been brought pursuant to § 10(b) and Rule 10b-5?"

On June 22, 2004, the SEC filed an Amicus Brief to address these and several other questions posed by the Second Circuit. The SEC answered the questions as follows:

1. Yes. The "in connection with" language in SLUSA has the same meaning it has under § 10(b) (Pet. App. 80a-83a);

2. No. Adoption of a purchaser-seller rule for SLUSA is neither consonant with the statutory language nor SLUSA's legislative purpose (Pet. App. 88a-94a); and

3. Yes. Where the statutory requirements are satisfied, SLUSA preempts class actions under state law that could not have been brought pursuant to § 10(b) and Rule 10b-5 (Pet. App. 87a, 95a-99a).

### C. *The Decision Below*

On January 11, 2005, the Second Circuit issued its opinion, affirming in part, vacating in part and remanding in part Judge Pollack's decision dismissing Dabit's complaint with prejudice. (Pet. App. 43a-52a.) The Second Circuit disagreed with the SEC (Pet. App. 26a-36a), and contravened the plain meaning of the statute. Instead, the Second Circuit held that "the purchaser-seller rule affirmed in *Blue Chip* applies to the construction of 'in connection with' under SLUSA" (Pet. App. 52a), reasoning that the legislative history of SLUSA did not suggest that Congress intended to preempt claims not "capable of being brought under federal law" (Pet. App. 21a).

Noting that Congress was aware of the judicially-created purchaser-seller standing requirement in private rights of action seeking damages under § 10(b) when it borrowed the "in connection with" language of § 10(b) in SLUSA, the Second Circuit concluded that Congress was "aware of and approve[d] that construction." (Pet. App. 29a.) The court held that "holders" claims were not preempted because *Blue Chip Stamps* applies as a limit on private rights of action under Section 10(b) and because the class of plaintiffs addressed

by SLUSA seek damages in private rights of action. The court stated, "it is . . . natural to suppose that Congress meant to import the settled standing rule along with the 'in connection with' phrase as a substantive standard." (Pet. App. 28a.)

The Second Circuit also cited the congressional goal of "closing the 'federal flight loophole' by stemming the migration of claims from federal to state court." (Pet. App. 21a.) Once again disagreeing with the SEC (Pet. App. 29a-35a; *compare* Pet. App. 88a-99a), the court concluded that SLUSA was intended to apply only to claims that could have been brought in federal court under the PSLRA:

> If the "in connection with" phrase is read to reach the same conduct under SLUSA as it does under § 10(b) and Rule 10b-5, then SLUSA will preempt precisely those state class actions which could be brought as federal actions subject to the heightened requirements of the PSLRA. If it were otherwise, actions might be preempted for meeting all of SLUSA's requirements, including the "in connection with" term, but not be capable of being brought under federal law for failure to meet the parallel requirement of Rule 10b-5, a result that the legislative history does not suggest Congress intended to produce in enacting SLUSA.

(Pet. App. 21a; *see also id.* 35a.)

Thus, the court below held that the purchaser-seller rule applies to the construction of "in connection with" under SLUSA. In so concluding, the Second Circuit disagreed with prior precedent from this Court and the SEC's view that the purchaser-seller requirement is not a construction of the "in

connection with the purchase or sale" requirement. (Pet. App. 26a-28a; *see* Pet. App. 80a-83a, 87a-94a.)

> [W]e find defendants' and the SEC's position concerning the applicability of *Blue Chip*'s purchaser-seller rule unpersuasive. Congress employed language with a settled judicial interpretation of which *Blue Chip* was a part and we see no clear indication either in the text or the legislative history of SLUSA of a congressional intent to abolish nonpurchaser and nonseller state class action claims.

(Pet. App. 27a.)

The court accordingly held that Respondent's state law claims for damages from "holding" securities are not preempted by SLUSA provided that he repleads so as to exclude from his putative class any person who purchased or sold securities during the putative class period. (Pet. App. 43a.)[4]

---

4. The Second Circuit's opinion below was addressed to two separate cases, *Dabit v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, Docket No. 03-7499 and *IJG Investments v. Merrill Lynch & Co.*, Docket No. 03-7458, which had been set for argument together. (*See* Pet. App. 1a.) Review is sought only of the portion of the decision in *Dabit* below holding that Respondent may avoid preemption by repleading his complaint to exclude from his putative class persons who traded the subject securities during the putative class period.

## REASONS FOR GRANTING THE PETITION

The decision below conflicts directly with a recent opinion of the Court of Appeals for the Seventh Circuit (Easterbrook, J.) on an important issue of federal statutory law that greatly impacts the nation's economy and capital markets. If allowed to stand, the decision below will undermine Congress's express purpose in enacting SLUSA: to provide a uniform national standard of liability for class actions seeking damages for misconduct alleged to affect nationally traded securities by eliminating "fragmentation of investor remedies" which "potentially impose[d] costs that outweigh[ed] the benefits" and thereby to promote the "efficient operation of those markets and the optimal allocation of available capital." S. Rep. No. 105-182, at 3-5 (1998), *available at* 1998 WL 266714, at *3-5 (interest in promoting efficient national markets was "compelling consideration").

### A. There is a Direct and Deep Conflict Among the Circuits Concerning the Question Presented in this Case.

The Second Circuit's holding in *Dabit*, interpreting SLUSA's "in connection with the purchase or sale of a . . . security" requirement as limited by the purchaser-seller rule of *Blue Chip Stamps*, squarely conflicts with the Seventh Circuit's holding that SLUSA's "in connection with" requirement does not incorporate the purchaser-seller rule. *See Kircher*, 2005 U.S. App. LEXIS 5372, at *11-15. The conflict is wide and deep and will not benefit from further percolation. The Third Circuit, though not reaching the issue, has suggested that it disagrees with the decision below because it conflicts with the views of the SEC and with

opinions of this Court. *See Rowinski v. Salomon Smith Barney Inc.*, 398 F.3d 294, 300-04 (3d Cir. 2005); *see* Pet. App. 72a-100a. The Eighth and Eleventh Circuits, under very different sets of facts, have simply concluded (without analysis) that the *Blue Chip Stamps* purchaser-seller rule is a judicial construction of the "in connection with" requirement, thereby aligning themselves with the Second Circuit. *See Green v. Ameritrade, Inc.*, 279 F.3d 590, 596-98 (8th Cir. 2002); *Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334, 1342-43 (11th Cir.), *cert. denied*, 537 U.S. 950 (2002).

As a result of the split in the circuits, SLUSA will necessarily fail in its purpose to establish uniform standards for conduct affecting nationally traded securities. This problem is exacerbated because the Second Circuit, as well as the Ninth and Eleventh Circuits, have held that they do not have appellate jurisdiction to review SLUSA remand orders, thereby rendering this issue incapable of further meaningful review. *See Williams v. AFC Enters., Inc.*, 389 F.3d 1185 (11th Cir. 2004); *Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 332 F.3d 116 (2d Cir. 2003); *Abada v. Charles Schwab & Co.*, 300 F.3d 1112 (9th Cir. 2002).

## B. The Second Circuit's Interpretation of SLUSA is Wrong on a Crucial Issue of Federal Statutory Law and Its Holding Will Eviscerate the Purpose of the Statute.

### 1. The Second Circuit's Reasoning Is Contrary to the Plain Language of the Statute and Is Flawed.

As set forth by Judge Easterbrook in *Kircher*, 2005 U.S. App. LEXIS 5372, and by the SEC in its *amicus* brief, the Second Circuit's reasoning is contrary to the plain language of the statute and is flawed. There is no dispute that Congress's use of the "in connection with a purchase or sale" language used in SLUSA has the same meaning as it does in § 10(b) of the Exchange Act, particularly since SLUSA amended the Exchange Act. Even the Second Circuit acknowledges this. (Pet App. 17a.)

Where the Second Circuit went wrong, however, was in its conclusion that the "in connection with" language is limited by the purchaser-seller standing requirement established in *Blue Chip Stamps*. (Pet. App. 52a.) The *Blue Chip Stamps* standing requirement is *not* a judicial construction of the "in connection with" requirement of § 10(b) of the Exchange Act. Instead, it is a judicially crafted limitation on standing that would prevent certain private plaintiffs from bringing actions that otherwise meet the statutory elements of § 10(b) of the Exchange Act, including the "in connection with" prong. *See Blue Chip Stamps*, 421 U.S. at 737-40 (explaining that such a rule was needed, citing "widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general"). As Justice O'Connor has explained, "[t]he purchaser/seller

standing limitation in Rule 10b-5 damages actions . . . does not stem from a construction of the phrase 'in connection with the purchase or sale of any security.'" *Holmes v. SIPC*, 503 U.S. 258, 284 (1992) (O'Connor, J., concurring in part and concurring in the judgment); *see also Kircher*, 2005 U.S. App. LEXIS 5372, at *12-13 (citing *United States v. O'Hagan*, 521 U.S. 642, 664 (1997); *Holmes v. SIPC*, 503 U.S. 258, 284 (1992); *United States v. Naftalin*, 441 U.S. 768, 774 n.6 (1979)); *Ontario Pub. Serv. Employees Union Pension Trust Fund v. Nortel Networks Corp.*, 369 F.3d 27, 34 (2d Cir. 2004) (the purchaser-seller limitation and "in connection with" are two distinct inquiries), *cert. denied*, 125 S. Ct. 919 (2005).

Where the language of a statute is plain, the courts should "enforce it according to its terms." *United States v. Ron Pair Enters.*, 489 U.S. 235, 241 (1989) (quoting *Caminetti v. United States*, 242 U.S. 470, 485 (1917)). Thus, as Judge Easterbrook explained in *Kircher*, "[t]o say that SLUSA uses the same language as § 10(b) and Rule 10b-5 is pretty much to resolve the point." *Kircher*, 2005 U.S. App. LEXIS 5372, at *11.

> Section 10(b) defines a federal crime, and it also permits the SEC to enforce the prohibition through administrative proceedings. Invocation of this anti-fraud rule does not depend on proof that the agency or United States purchased or sold securities; instead the "in connection with" language ensures that the fraud occurs in securities transactions rather than some other activity. *See SEC v. Zandford*, 535 U.S. 813, 821-22, 153 L. Ed. 2d 1 (2002); *Superintendent of Insurance*

*v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12, 30 L. Ed. 2d 128 (1971).

*Kircher*, 2005 U.S. App. LEXIS 5372, at *11-12. Indeed, this is the very reasoning employed by the SEC in responding to the Second Circuit's inquiry. (Pet. App. 80a-87a.)

Judge Easterbrook also explained: "*Blue Chip Stamps* came out as it did . . . because a private right of action to enforce these provisions is a judicial creation and the Court wanted to confine these actions to situations where litigation is apt to do more good than harm." *Id.* at *12 ("The Justices observed that anyone can *say* that a failure to trade bore some relation to what the issuer did (or didn't) disclose."). *Blue Chip Stamps*' purchaser-seller requirement limits "private actions to harms arising out of actual trading, which narrows the affected class and simplifies proof, while leaving other securities offenses to public prosecutors." *Id.* Thus, by limiting their putative classes to persons who did not trade any securities, plaintiffs did not thereby take their claims outside of § 10(b) and Rule 10b-5's "in connection with" requirement; "instead they demonstrate only that the claims must be left to public enforcement." *Id.* at *13.

Because the purchaser-seller requirement of *Blue Chip Stamps* is not a construction of the "in connection with" requirement of the federal securities laws, but rather serves the entirely separate purpose of limiting judicially implied private rights of action under federal law, there is no basis to import that limit to SLUSA. To the contrary, as explained more fully below, to hold otherwise, as did the court below, would be to allow individuals a private right of action to bring, as class actions, securities claims under state law that are expressly *disallowed* under federal law.

### 2. The Second Circuit's Decision Will Undermine the Express Purpose of the Statute.

If allowed to stand, the Second Circuit's reasoning will undermine the very purpose of SLUSA. More than twenty years before the enactment of the PSLRA and SLUSA, this Court recognized that the nature of securities actions, as well as liberal discovery provisions of the Federal Rules of Civil Procedure, presented the real possibility of abuse in that such actions will have a settlement value out of proportion to their prospect of success at trial. *See Blue Chip Stamps*, 421 U.S. at 740. Twenty years later, Congress found that such abuses, especially in the class action context, were having a deleterious impact on the nation's economy and the capital markets. To cure this problem, Congress enacted the PSLRA which, among other things, heightened the pleading requirements for alleging claims under the federal securities laws. *See* H.R. Conf. Rep. No. 104-369, at 31-32, 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730-31, 740). It did not take long, however, before creative plaintiffs' securities lawyers sought to find ways around the PSLRA and began to bring actions in the state courts. To remedy this "federal flight" and to ensure that national, federal standards would be applied to nationally traded securities, Congress enacted the Securities Litigation Uniform Standards Act of 1998. *See Lander*, 251 F.3d at 107-08.

As its name suggests, SLUSA was intended to ensure that, in the class action context, the federal securities laws would dictate a uniform standard of liability for conduct involving nationally traded securities. Congress "found the interest in promoting efficient national markets to be the . . . compelling consideration in this context." S. Rep. No. 105-182, at 4 (1998), *available at* 1998 WL 266714, at *4. As long as there is a split in the circuits as to what "in connection with" means in the

context of SLUSA preemption, the congressional goal of uniform standards will be defeated. Furthermore, the likelihood of inconsistent standards being applied is greatly exacerbated because the majority of circuits to have considered the question hold that remand orders issued after removal under SLUSA are unreviewable by the circuits. *See Williams*, 389 F.3d 1185; *Spielman*, 332 F.3d 116; *Abada*, 300 F.3d 1112.

Since the enactment of SLUSA, the plaintiffs securities bar has responded again by trying to take advantage of what they perceive as a loophole in the congressional intent to subject such actions to one federal standard. Equating SLUSA's 'in connection with' language with being "'able to pursue a private right of action after *Blue Chip Stamps*,'" *Kircher*, 2005 U.S. App. LEXIS 5372, at *9, the plaintiffs' bar has brought a variety of class actions purporting to assert harms arising out of "holding" securities. While prior to SLUSA's passage such cases were all but non-existent, they have proliferated at an alarming rate.[5] And yet, non-trading

5. Published and electronically available opinions include: *Prof'l Mgmt. Assocs. v. KPMG LLP*, 335 F.3d 800 (8th Cir. 2003) *cert. denied*, 540 U.S. 1162 (2004); *Riley v. Merrill Lynch, Pierce, Fenner & Smith*, 292 F.3d 1334 (11th Cir. 2002); *Davis v. Kozlowski*, 2005 U.S. Dist. LEXIS 4481 (D.N.H. Mar. 17, 2005); *Atencio v. Smith Barney*, 2005 U.S. Dist. LEXIS 1526 (S.D.N.Y. Feb. 2, 2005); *Gordon v. Buntrock*, 2005 U.S. Dist. LEXIS 57 (N.D. Ill. Jan. 3, 2005); *In re Alger, Columbia, Janus, MFS, One Group, & Putnam Mut. Fund Litig.*, 320 F. Supp. 2d 352 (D. Md. 2004); *Grabow v. PricewaterhouseCoopers LLP*, 313 F. Supp. 2d 1152 (N.D. Okla. 2004); *Vogeler v. Columbia Acorn Trust*, 2004 U.S. Dist. LEXIS 9182 (S.D. Ill. Feb. 12, 2004); *Potter v. Janus Inv. Fund*, 2004 U.S. Dist. LEXIS 9181 (S.D. Ill. Feb. 9, 2004); *Meyer v. Putnam Int'l Voyager Fund*, 220 F.R.D. 127 (D. Mass. 2004); *Kircher v. Putnam Funds Trust*, 2004 U.S. Dist. LEXIS 10327 (S.D. Ill. Jan. 23, 2004); *Bradfisch v. Templeton Funds, Inc.*, 319 F. Supp. 2d 897 (S.D. Ill. (Cont'd)

"holder" claims under state law were precisely the "sort of maneuver[ing] that SLUSA is designed to prevent." *Kircher*, 2005 U.S. App. LEXIS 5372, at *15. SLUSA's "preemptive effect is not confined to knocking out state-law claims by investors who have *winning* federal claims, as plaintiffs suppose. It covers both good and bad securities claims – *especially* bad ones." *Id.* at *15; *see also* Pet. App. 77a-80a, 93a, 95a-99a ("Were the [purchaser-seller] rule to apply under SLUSA it would have the opposite effect [from its effect in *Blue Chip Stamps*], in that it would allow lawsuits with precisely these vexatious characteristics to go forward.").

The decision below now judicially approves the opening of the door to this improper loophole which can only now be shut through the resolution of the split amongst the Circuits.

---

(Cont'd)

2004); *Cape Ann Investors LLC v. Lepone*, 296 F. Supp. 2d 4 (D. Mass. 2003); *Gordon v. Variable Prods. Fund III*, 2003 U.S. Dist LEXIS 24738 (S.D. Fla. Dec. 4, 2003); *Ray v. Citigroup Global Mkts., Inc.*, 2003 U.S. Dist. LEXIS 20966 (N.D. Ill. Nov. 20, 2003); *Feitelberg v. Credit Suisse First Boston LLC*, 2003 U.S. Dist. LEXIS 19116 (N.D. Cal. Oct. 21, 2003); *Tittle v. Enron Corp.*, 284 F. Supp. 2d 511 (S.D. Tex. 2003); *Dacey v. Morgan Stanley Dean Witter & Co.*, 263 F. Supp. 2d 706 (S.D.N.Y. 2003); *Chinn v. Belfer*, 2002 U.S. Dist. LEXIS 20343 (D. Or. June 19, 2002); *Korsinsky v. Salomon Smith Barney*, 2002 U.S. Dist. LEXIS 259 (S.D.N.Y. Jan. 9, 2002); *Hardy v. Merrill Lynch, Pierce, Fenner & Smith*, 189 F. Supp. 2d 14 (S.D.N.Y. 2001); *Shaev v. Claflin*, 2001 U.S. Dist. LEXIS 6677 (N.D. Cal. May 16, 2001); *Gutierrez v. Deloitte & Touche, L.L.P.*, 147 F. Supp. 2d 584 (W.D. Tex. 2001); *Gordon v. Buntrock*, 2000 U.S. Dist. LEXIS 5977 (N.D. Ill. Apr. 28, 2000).

As Judge Easterbrook aptly put it:

> It would be more than a little strange if the Supreme Court's decision to block private litigation by non-traders became the opening by which that very litigation could be pursued under state law, despite the judgment of Congress (reflected in SLUSA) that securities class actions must proceed under federal securities law or not at all. *Blue Chip Stamps* combined with SLUSA may mean that claims of the sort plaintiffs want to pursue must be litigated as derivative actions or committed to public prosecutors, but this is not a good reason to undercut the statutory language.

*Kircher*, 2005 U.S. App. LEXIS 5372, at *13. "[P]laintiffs' effort to define non-purchaser-non-seller classes is designed to evade PSLRA in order to litigate a securities class action in state court . . . . It is the very sort of maneuver that SLUSA is designed to prevent." *Id.* at *14-15.

### C. This Case Presents a Unique and Necessary Opportunity to Resolve the Circuit Conflict and Restore the Intent of SLUSA.

This case presents an appropriate vehicle and opportunity for this Court to resolve the Circuit conflict and the dispute over the breadth of SLUSA's preemption. As discussed above, the differing standards now being employed by the Circuits undermine the express statutory purpose underlying SLUSA and open the floodgates to an entirely new type of private securities class action – holding claims, which this Court expressly disallowed under federal law – by creating the purchaser-seller requirement.

While the split amongst the Circuit goes unresolved, these types of "holding" claims will only proliferate. *See supra* note 5. This concern is paramount here where it is the Second Circuit that has judicially opened the floodgates to such actions. The Second Circuit has been described as the "Mother Court" of federal securities jurisprudence. *See Blue Chip Stamps*, 421 U.S. at 762 (Blackmun, J., dissenting). Because the securities at issue are traded nationally, plaintiffs can virtually select any forum in which to bring their claims. Thus, as long as there is at least one such forum like the Second Circuit that allows such state law claims to proceed, it will serve as a portal for any plaintiff anywhere in the country to bring such claims, further undermining the purpose of SLUSA.

This presents an intolerable situation to publicly-listed companies and their shareholders, not to mention the nation's financial community. *See* S. Rep. No. 105-182, at 4 (1998), *available at* 1998 WL 266714, at *4 (state class-action litigation impairs capital formation and diverts resources, impairing the efficiency of our capital markets). Recognizing the *in terrorem* and other deleterious effects of allowing such state law claims to proceed, the statutory framework of SLUSA provides that any such actions can be immediately removed to federal court (if necessary) and then immediately dismissed. Moreover, SLUSA applies to preempt a breadth of actions involving a wide variety of financial products, including common stock, mutual funds, annuities and other insurance products. *See, e.g.*, *Lander*, 251 F.3d 101; *Kircher*, 2005 U.S. App. LEXIS 5372. Indeed, the only way to accomplish the congressional goals behind SLUSA – to establish uniform, federal standards and prevent federal flight – was to enact a statute of complete preemption that operates to dismiss such preempted actions at the outset of the litigation.

To allow this case to proceed will defeat the purpose of the statute by forcing Merrill Lynch to embark on costly and distracting litigation, which Congress expressly sought to prevent in enacting the PSLRA and SLUSA. In enacting the PSLRA and SLUSA, Congress explicitly recognized that the threat of costly and burdensome discovery is one tactic by which "innocent parties are often forced to pay exorbitant 'settlements.'" H.R. Conf. Rep. No. 104-369, at 32 (1995), *reprinted in* 1995 U.S.C.C.A.N. at 731. As the House Report noted, "[i]nvestors always are the ultimate losers when extortionate 'settlements' are extracted from issuers." *Id.* The harms here are even more amplified because the same core allegations asserted in this case would not be sufficient to support a federal claim for securities fraud. *See Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005). This is precisely the situation Congress sought to avoid in enacting SLUSA.

The question presented in this petition will not be further refined or resolved by allowing it to further percolate amongst the Circuit courts. The question presented is a discrete – yet extremely important – issue of law which has now been decided definitively – in opposite ways – in at least the Second and Seventh Circuits. Furthermore, as discussed above, the Second Circuit (as well as the Ninth and Eleventh Circuits) has held that it lacks appellate jurisdiction over SLUSA remand orders. Accordingly, there will be no further opportunities for the Second Circuit to refine its jurisprudence, or for that matter, to provide for a ripe Circuit split again for this Court to resolve.

## CONCLUSION

For the foregoing reasons, the petition for a writ of *certiorari* should be granted. Petitioner also respectfully suggests that the Court's consideration of this Petition may be enhanced by receiving the views of the Solicitor General.

Respectfully submitted,

JAY B. KASNER
*Counsel of Record*
EDWARD J. YODOWITZ
SCOTT D. MUSOFF
JOANNE GABORIAULT
SKADDEN, ARPS, SLATE,
MEAGHER & FLOM LLP
Four Times Square
New York, New York 10036
(212) 735-3000

*Counsel for Petitioner*

*Of Counsel*:
PREETA D. BANSAL

# APPENDIX

**APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT DECIDED JANUARY 11, 2005**

**UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT**

August Term 2003

(Argued: December 15, 2003 Decided: January 11, 2005)

Docket Nos. 03-7499, 03-7458

---

SHADI DABIT,
on behalf of himself and all others similarly situated,

*Plaintiff-Appellant*,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
a corporation,

*Defendant-Appellee*.

---

IJG INVESTMENTS and IRLYS GUY,
on behalf of themselves and all others similarly situated,

*Plaintiffs-Appellants*,

v.

MERRILL LYNCH & CO., INC.,

*Defendant-Appellee*.

---

Before: OAKES, SOTOMAYOR and WESLEY, *Circuit Judges*.

*Appendix A*

SOTOMAYOR, *Circuit Judge*:

These two separate appeals, consolidated for purposes of oral argument and opinion, present an issue of first impression in this Circuit: whether the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), Pub. L. No. 105-353, 112 Stat. 3227, which preempts certain class actions based upon state law brought by private parties alleging a misrepresentation or omission "in connection with the purchase or sale" of certain nationally traded securities, SLUSA § 101(b), 112 Stat. at 3230 (codified at 15 U.S.C. § 78bb(f)), preempts claims that do not allege that putative class members purchased or sold particular securities in reliance upon the defendant's alleged misconduct. Plaintiffs brought the instant actions in the wake of an investigation by the New York Attorney General into conflicts of interest that arose within certain large investment firms. Both actions alleged that defendants-appellees Merrill Lynch & Co., Inc. and Merrill Lynch Pierce Fenner Smith, Inc. (collectively, "Merrill Lynch")[1] issued biased research and investment recommendations designed to garner investment banking business and sought relief under state law. Plaintiff-appellant Shadi Dabit ("Dabit") brought a putative class action against Merrill Lynch in the United States District Court for the Western District of Oklahoma on diversity grounds. Plaintiffs-appellants IJG Investments Limited Partnership ("IJG Investments") and Irlys Guy (collectively, "IJG")

1. Defendant-appellee Merrill Lynch & Co. is the parent company of defendant-appellee Merrill Lynch, Pierce, Fenner & Smith Inc. Because the corporate structure of these companies is not relevant on this appeal, we refer to defendants throughout this opinion simply as "Merrill Lynch."

brought a putative class action against Merrill Lynch in Minnesota state court. After removal of the IJG action to federal court and subsequent coordinated proceedings of both actions in the Southern District of New York, the district court dismissed the lawsuits under Federal Rule of Civil Procedure 12(b)(6) as preempted by SLUSA.

On appeal, plaintiffs contend that SLUSA does not preempt their actions because their complaints do not allege misrepresentations or omissions of material fact "in connection with the purchase or sale of . . . covered securit [ies]." Dabit argues that SLUSA's "in connection with" requirement is not satisfied because he seeks only (i) "holding" damages—damages incurred because Merrill Lynch fraudulently induced him to retain certain securities—and (ii) commissions that he would have earned from clients that he lost by recommending securities touted in Merrill Lynch's allegedly false research reports. IJG argues that preemption is inappropriate because it seeks merely "the cost of doing business"—specifically, flat fees and commissions—relating to IJG's payments for access to Merrill Lynch's proprietary research, a nexus asserted to be insufficiently "in connection with" the purchase or sale of securities to trigger preemption.

For reasons to be discussed, we hold that (i) the meaning of "in connection with" under SLUSA is coterminous with the meaning of the nearly identical language of § 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Pub. L. No. 73-291, 48 Stat. 881, 891 (1934) (codified at 15 U.S.C. § 78j(b)), and its corresponding Rule 10b-5, 17 C.F.R. § 240.10b-5, and (ii) the purchaser-seller rule of

*Appendix A*

*Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), applies as a limit on SLUSA's "in connection with" requirement such that SLUSA does not preempt claims that do not allege purchases or sales made by the plaintiff or the alleged class members. Dabit's "holding" and IJG's commissions-based claims satisfy SLUSA's conditions requiring preemption because they contain implicit allegations of purchases made by plaintiffs and putative class members. Thus, we affirm the judgment below to the extent it found these claims preempted. We vacate, however, so much of the judgment as dismissed Dabit's lost-commission claim and dismissed the remaining claims with prejudice, and remand to the district court to dismiss these claims without prejudice so that plaintiffs may (if the pertinent facts warrant) bring new actions that do not include allegations of fraud "in connection with the purchase or sale of a . . . security."

## BACKGROUND

We summarize below the allegations of Dabit's and IJG's complaints, and assume their truth, as we must upon review of a dismissal pursuant to Federal Rule of Civil Procedure 12(b)(6). *Ideal Steel Supply Corp. v. Anza*, 373 F.3d 251, 254 (2d Cir. 2004).

### 1. Dabit's Complaint and Amended Complaint

Dabit, a former broker of Merrill Lynch, initially sued on April 26, 2002, on behalf of himself and other current and former Merrill Lynch brokers who, from December 1, 1999, through December 31, 2000, (i) purchased and

refrained from selling Merrill Lynch-recommended securities because of Merrill Lynch's misleading research and recommendations, and (ii) lost clients as a result of purchases of recommended stocks on behalf of clients and Merrill Lynch's alleged misconduct. Dabit alleged breaches of fiduciary duty and of the covenants of good faith and fair dealing (presumably under Oklahoma law—the complaint does not tell us). Dabit filed his action in the United States District Court for the Western District of Oklahoma, alleging jurisdiction on diversity grounds. The complaint attached two exhibits: a list of stocks purchased by Dabit and recommended to Dabit's alleged lost customers during the class period based on Merrill Lynch's recommendation (the "ML stocks"); and a report prepared by the Office of the Attorney General of New York concerning Merrill Lynch's scheme to attract investment banking business by overrating certain stocks and causing the inflation of their prices. The complaint further alleged that Merrill Lynch's "manipulative efforts," which included illegal sales efforts described as "the hallmarks of stock manipulation," caused these stocks to trade at "artificially inflated" prices. On October 11, 2002, the district court dismissed Dabit's initial complaint as preempted by SLUSA, calling it a "hopeless melange of purchase-related and holding-related assertions." Nevertheless, the district court allowed Dabit to re-plead because it was "conceivable that claims based on wrongfully-induced holding could be pleaded."

In his amended complaint, filed on October 21, 2002, Dabit replaced the original complaint's numerous references to purchases of securities with references instead to the

owning or holding of securities. For example, Dabit's putative class was amended to include those brokers who

> owned and continued to own one or more of the [Merrill Lynch] recommended securities . . . or recommended such securities to their clients during the period of December 1, 1999 through December 31, 2000[,] . . . and who suffered damages as a result of owning and holding such [Merrill Lynch] Stocks during this time period, or who suffered damages as a consequence of the loss of clients due to [Merrill Lynch's] wrongful actions. . . .

Dabit also removed the original complaint's discussion of Merrill Lynch's alleged illegal sales efforts. The amended complaint, however, attached the same exhibits as the original complaint and contained several of the same allegations concerning Merrill Lynch's causing certain stocks to trade at "artificially inflated" prices through the use of deceptive devices alleged to be the "hallmarks of stock manipulation." As in the initial complaint, the breach of fiduciary duty and breach of covenants of good faith and fair dealing were the only claims asserted.

On October 23, 2002, the Judicial Panel for Multidistrict Litigation conditionally transferred the Dabit action to the Southern District of New York where more than 120 additional cases against Merrill Lynch arising from the New York Attorney General's investigation were being centralized. The Panel also transferred five other putative class actions alleging state law claims in connection with Merrill Lynch's

false research (including IJG's action) to the Southern District of New York for coordinated proceedings before Judge Pollack. Merrill Lynch moved to dismiss Dabit's complaint under Rule 12(b)(6) as preempted by SLUSA.

**2. IJG's Complaint**

On June 7, 2002, IJG filed its putative class action in Minnesota state court, asserting breach of contract and consumer fraud claims under Minnesota law for damages arising from its relationship as a retail brokerage customer of Merrill Lynch.[2] The crux of IJG's complaint is that Merrill Lynch provided biased investment advice in violation of its contract with IJG.

The contracts at issue arose out of retail cash management accounts opened by IJG Investments, an investment partnership, and Guy, an individual investor, with Merrill Lynch. Specifically, Guy maintained a cash management account with Merrill Lynch, and the partnership held the business counterpart of that account, a working capital management account. Merrill Lynch charged IJG an annual participation fee for subscription to these accounts, which IJG paid. IJG asserts that it and Merrill Lynch understood that the fees paid were in exchange for objective

---

2. IJG alleged violations of the Minnesota Consumer Fraud Act, Minn. Stat. §§ 325F.68-.70, the Uniform Deceptive Trade Practices Act, Minn. Stat. § 325D.43-.48, and Minn. Stat. § 325F.71, which provides additional penalties for certain violations of those two statutes when perpetrated against senior citizens or handicapped persons, as well as common-law breaches of contract and the duty of good faith and fair dealing.

research promised by Merrill Lynch. Merrill Lynch also charged IJG commissions for engaging in securities trades in its brokerage account.

IJG's complaint, like Dabit's, alleged that Merrill Lynch issued false and misleading reports concerning publicly traded securities in order to garner investment banking business for Merrill Lynch. Despite the alleged understanding that IJG paid fees and commissions in exchange for objective research, the complaint asserted, Merrill Lynch "routinely used biased advice as a way to curry favor with various companies in order to sell investment banking services to those companies" and in return "earned lucrative investment banking fees."

IJG defined its putative class to include "[a]ll persons or entities who maintained retail brokerage accounts with Merrill Lynch, and who paid a commission or fees to Merrill Lynch." The complaint sought damages for injuries caused by the research reports' lack of objectivity. Under one cause of action, IJG alleged that Merrill Lynch's "conduct caused senior citizens to suffer a substantial loss of property set aside for retirement or for personal or family care and maintenance." Notwithstanding this broad description of potential damage claims regarding senior citizens, IJG's prayer for relief asserted that it sought only restitution of "funds wrongly withheld, charged or retained" by Merrill Lynch and "actual damages including, but not limited to, attorney fees, costs and expenses incurred in paying for valueless services." IJG maintains on this appeal that it seeks to recover only the amounts paid as (i) flat fees and (ii) commissions paid for purchases or sales of securities

falsely reviewed by Merrill Lynch, and thus not on any losses stemming from the diminished values of securities actually bought or sold.

On July 5, 2002, Merrill Lynch removed the IJG action to the United States District Court for the District of Minnesota on the grounds of diversity and SLUSA preemption. The Judicial Panel for Multidistrict Litigation conditionally transferred the case to the Southern District of New York on November 27, 2002 and consolidated it with several other actions before Judge Pollak (including Dabit's) related to Merrill Lynch's allegedly improper stock research. IJG moved to remand its case on January 9, 2003. In opposition, as discussed above, Merrill Lynch moved to dismiss the complaint and three of the other complaints, including Dabit's, pursuant to Rule 12(b)(6) for failure to state a claim as a result of SLUSA preemption.

### 3. The District Court's Dismissal of Both Actions

In an opinion and decision dated April 10, 2003, the district court denied IJG's motion to remand and dismissed, *inter alia*, both actions with prejudice as preempted under SLUSA. The district court found the state law claims to be "based on the very same alleged series of transactions and occurrences asserted in the federal securities actions currently being coordinated before this Court," and held that the claims "fall squarely within SLUSA's ambit" because they allege "misrepresentations or omissions of material facts or [a] manipulative or deceptive device or contrivance in connection with the purchase or sale of a nationally traded security." These timely appeals followed.

*Appendix A*

## DISCUSSION

We review *de novo* a ruling dismissing an action for failure to state a claim pursuant to Rule 12(b)(6). *Ortiz v. McBride*, 380 F.3d 649, 653 (2d Cir. 2004). All inferences must be drawn in favor of the nonmoving party. *Id.* We may affirm the dismissal only if " 'it appears beyond doubt that the plaintiff[s] can prove no set of facts in support of [their] claim[s] which would entitle [them] to relief.' " *McEachin v. McGuinnis*, 357 F.3d 197, 200 (2d Cir. 2004) (quoting *Flores v. S. Peru Copper Corp.*, 343 F.3d 140, 148 (2d Cir. 2003) (quoting *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957))). The district court's determination regarding SLUSA preemption is a conclusion of law and we therefore review it *de novo*. *See Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 107 (2d Cir. 2001).

### 1. SLUSA's Enactment and Scope

Congress enacted SLUSA in 1998 in response to the perceived failure of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104- 67, 109 Stat. 737 (codified in part at 15 U.S.C. § § 77z-1, 78u-4) to curb abuses of federal securities fraud litigation arising under the Securities Act of 1933 ("Securities Act"), Pub. L. No. 73-22, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. § 77a *et seq.*), and the Exchange Act. SLUSA § 2, 112 Stat. at 3227; *Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334, 1340 (11th Cir. 2002); *Lander*, 251 F.3d at 107-08. In construing the meaning of terms found in SLUSA, "we must view SLUSA in this larger statutory context." *Riley*, 292 F.3d at 1340.

## *Appendix A*

Section 10(b) of the Exchange Act makes it "unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe. . . ." 15 U.S.C. § 78j(b). The SEC promulgated an accompanying rule, Rule 10b-5, which provides in part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> *in connection with the purchase or sale of any security.*

17 C.F.R. § 240.10b-5 (emphasis added). Although Congress initially enacted § 10(b) "envision[ing] that the SEC would enforce the statutory prohibition through administrative and

injunctive actions," *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994), *abrogated on other grounds by* PSLRA § 104, 109 Stat. at 757 (codified at 15 U.S.C. § 78t), the federal courts have long recognized that the statute and its implementing rule give rise to a private cause of action for damages and injunctive relief. *See Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971); *see also Blue Chip*, 421 U.S. at 730 (noting that judicial implication of private right of action under § 10(b) and Rule 10b-5 provides "'a necessary supplement to Commission action.'" (citing *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964))).

Finding that plaintiffs were abusing this private cause of action by bringing meritless class actions—so-called "strike suits"—in the hope of coercing large settlements, Congress enacted the PSLRA in 1995 to provide more stringent and uniform standards for securities fraud class actions and other suits that alleged fraud in the securities markets. *See Lander*, 251 F.3d at 107 (citing H.R. Conf. Rep. No. 105-803 (1998)). Among other reforms, the PSLRA imposed heightened pleading standards for class actions alleging fraud in the sale of national securities and imposed a mandatory stay on discovery pending judicial determination of the legal sufficiency of the claims.[3] PSLRA § § 101(a),(b), 109 Stat. at 741, 746-47 (codified at 15 U.S.C. § § 77z-1(b), 78u-4(b)).

---

3. In addition, because of perceived inefficiencies inherent in dual state and federal securities registration schemes, Congress passed the National Securities Markets Improvement Act of 1996 ("NSMIA"), Pub. L. No. 104-290, 110 Stat. 3416 (codified in part at 15 U.S.C. § 77r), primarily to preempt state "Blue Sky" laws that required issuers to register many securities with state authorities prior to marketing in the states. *See Lander*, 251 F.3d at 108.

*Appendix A*

As noted above, Congress enacted SLUSA in 1998 in response to the perceived failure of the PSLRA to achieve its goals. Congressional investigation revealed a "federal flight" loophole whereby many class action plaintiffs avoided the PSLRA's heightened requirements by bringing suit in state courts under state statutory or common law rather than in federal court. *See Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 332 F.3d 116, 123 (2d Cir. 2003); *Lander*, 251 F.3d at 108 ("[T]he decline in federal securities class action suits that occurred after the passage of [the] PSLRA was accompanied by a nearly identical increase in state court filings." (citing H.R. Conf. Rep. No. 105-803)); *see also* SLUSA § (2), 112 Stat. at 3227. In enacting SLUSA, Congress intended to close this loophole "by making federal court the exclusive venue for class actions alleging fraud in the sale of certain covered securities and by mandating that such class actions be governed exclusively by federal law." *Lander*, 251 F.3d at 108.

In pertinent part, SLUSA provides that:

> No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—
>
> (A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or
>
> (B) that the defendant used or employed any manipulative or deceptive device or

> contrivance in connection with the purchase or sale of a covered security.

15 U.S.C. § 78bb(f)(1).[4] It further provides that such actions may be removed to federal court. 15 U.S.C. § 78bb(f)(2). Thus, four conditions must be satisfied to trigger SLUSA's removal and preemption provisions: (1) the underlying suit must be a "covered class action"[5]; (2) the action must be

4. SLUSA defines a "covered security" as "a security that satisfies the standards for a covered security specified in paragraph (1) or (2) of section 18(b) of the Securities Act of 1933, at the time during which it is alleged that the misrepresentation, omission, or manipulative or deceptive conduct occurred. . . ." 15 U.S.C. § 78bb(1)(5)(E). Section 18(b) of the Securities Act of 1933 includes securities that are listed or authorized for listing on certain national securities exchanges. 15 U.S.C. § 77r(b)(1).

5. SLUSA defines a "covered class action" as:

> (i) any single lawsuit in which—
>
> > (I) damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individual persons or members; or
> >
> > (II) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated, and questions of law or fact common to

(Cont'd)

based on state or local law; (3) the action must concern a "covered security"; and (4) the defendant must have misrepresented or omitted a material fact or employed a manipulative or deceptive device or contrivance "in connection with the purchase or sale of" that security. *Riley*, 292 F.3d at 1342.

This Court has noted that in enacting SLUSA, "Congress could not have spoken more clearly" about its intention "to completely preempt the field of certain types of securities class actions by essentially converting a state law claim into a federal claim and creating federal jurisdiction and venue for specified types of state securities fraud claims." *Spielman*, 332 F.3d at 123 (emphasis omitted). As we explained in *Spielman*, complete preemption "manifests a [c]ongressional policy determination that the 'state law claim in that area is of necessity so federal in character that it arises under federal

---

(Cont'd)

> those persons or members of the prospective class predominate over any questions affecting only individual persons or members; or
>
> (ii) any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which—
>
> (I) damages are sought on behalf of more than 50 persons; and
>
> (II) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.

15 U.S.C. § 78bb(f)(5)(B).

law.' " *Id.* at 123 n. 5 (quoting *Cicio v. Does*, 321 F.3d 83, 92 (2d Cir. 2003) (further internal quotation omitted)). It therefore "provides in practice an exception to the well-pleaded complaint rule," *id.*, such that when SLUSA's conditions have been satisfied, "the plaintiff has necessarily invoked federal question jurisdiction, even though he [or she] did not wish to," and the court must dismiss for failure to state a claim because SLUSA has preempted the state law basis for the claim, *id.* at 131-32 (Newman, J., concurring).

Under SLUSA, then, we must look beyond the face of the complaint to analyze the substance of the allegations made. "[P]erhaps mindful that SLUSA was intended to block artful plaintiffs, courts have gone beyond asking whether the removed complaint contains the talismanic phrase 'in connection with,' and have looked also to whether the allegations, if true, would satisfy the 'in connection with' requirement." *Id.* at 133 n.5; *see also Dudek v. Prudential Sec., Inc.*, 295 F.3d 875, 879 (8th Cir. 2002) (stating that where complete preemption applies, "plaintiff may not avoid federal question jurisdiction and the preemption of state law claims by artfully concealing the federal question in an otherwise well-pleaded complaint under state law").

Both IJG and Dabit allege that Merrill Lynch misrepresented the value of certain stocks, which are concededly covered securities under SLUSA, in order to attract investment banking business, all in violation of either Minnesota or Oklahoma law. Accordingly, plaintiffs do not dispute that their lawsuits are SLUSA "covered class actions" based upon state statutory or common law or, with the exception of one of IJG's claims, that they involve

misrepresentations and omissions that concern SLUSA-defined "covered securities." Rather, the principal question on this appeal is whether these purported misrepresentations and omissions were alleged to be "in connection with the purchase or sale" of the covered securities for purposes of SLUSA.

### 2. SLUSA's "In Connection With" Requirement

#### A. The Applicability of § 10(b) and Rule 10b-5 Jurisprudence

In determining the meaning of the broad phrase "in connection with the purchase or sale of a covered security" under SLUSA, we turn first to the language of the statute, for "[t]he starting point in every case involving construction of a statute is the language itself." *Blue Chip*, 421 U.S. at 756 (Powell, J., concurring). SLUSA, however, nowhere defines the phrase, and the Supreme Court has not yet interpreted this phrase in the context of SLUSA. The phrase has been extensively interpreted by the Supreme Court and the lower federal courts in the context of § 10(b) and Rule 10b-5, *see Blue Chip*, 421 U.S. at 731-32, and the parties and the SEC as *amicus curiae* urge us to refer to this body of law in construing SLUSA. We are persuaded that this is the correct approach.[6]

---

6. After oral argument in these cases, the Court *sua sponte* invited the Securities and Exchange Commission (the "SEC" or the "Commission") to submit its views on the issues presented in this appeal. Accepting our invitation, the SEC submitted an *amicus curiae* brief. Where Congress has expressly or impliedly "delegat[ed]

(Cont'd)

(Cont'd)

authority to [an] agency to elucidate [an ambiguous] . . . provision of [a] statute," the agency's interpretation will be given controlling weight so long as it is reasonable. *Chevron, U.S.A., Inc. v. Natural Res. Def. Council*, 467 U.S. 837, 843-44 (1984); *see also In re New Times Sec. Servs.*, 371 F.3d 68, 80 (2d Cir. 2004). The preemptive provisions of SLUSA, however, unlike the parallel provisions of § 10(b), do not create powers in the SEC or vest the SEC with any rulemaking, adjudicative or other enforcement or interpretive responsibility. Because *Chevron* deference is due only where "Congress would expect the agency to be able to speak with the force of law when it addresses ambiguity in the statute or fills a space in the enacted law" and where "the agency interpretation claiming deference was promulgated in the exercise of that authority," *United States v. Mead Corp.*, 533 U.S. 218, 226-27, 229 (2001), we do not apply it to the SEC's views concerning the meaning of SLUSA.

Where, as here, *Chevron* deference is inappropriate but "the agency has some special claim to expertise under the statute," the court defers to the agency's view to the lesser degree of extending "*Skidmore* deference." *Coke v. Long Island Care At Home, Ltd.*, 376 F.3d 118, 133 (2d Cir. 2004) (internal quotation and citation omitted). The level of deference owed to an agency's view under *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944), depends on "all those factors which give it power to persuade, if lacking power to control," *id.* at 140, including "the agency's expertise, the care it took in reaching its conclusions, the formality with which it promulgates its interpretations, the consistency of its views over time, and the ultimate persuasiveness of its arguments." *Cmty. Health Ctr. v. Wilson-Coker*, 311 F.3d 132, 138 (2d Cir. 2002) (citing *Mead*, 533 U.S. at 228, 234-35). Because, for reasons explained *infra*, we would independently reach the same conclusion as the SEC on the applicability of § 10(b) jurisprudence to the meaning of SLUSA's "in connection with" requirement, we need not engage in exhaustive analysis of these factors. *See id.* at 137-38 (declining to specify "the exact molecular weight of deference" owed to agency's position where not outcome-determinative).

*Appendix A*

All of the federal courts of appeals that have considered the issue have relied upon judicial interpretation of "in connection with" under § 10(b) and Rule 10b-5 in construing SLUSA. *See Riley*, 292 F.3d at 1342 (listing circuit court and district court cases); *see also Falkowski v. Imation Corp.*, 309 F.3d 1123, 1129 (9th Cir. 2002); *Green v. Ameritrade, Inc.*, 279 F.3d 590, 597-98 (8th Cir. 2002).[7] In concluding that § 10(b) and Rule 10b-5 jurisprudence concerning the "in connection with" language applies to SLUSA, the Eleventh Circuit reasoned that "where Congress uses terms that have accumulated settled meaning under either equity or the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms." *Riley*, 292 F.3d at 1342 (internal quotation and alteration marks omitted). Further, as observed in *Riley* and by the Ninth Circuit in *Falkowski*, the application of § 10(b) jurisprudence is particularly appropriate because SLUSA is legislation intended to shore up the PSLRA, which in turn related to abuse of that provision. *Falkowski*, 309 F.3d at 1129 ("SLUSA should . . . be viewed as part of the remedial package of federal securities laws and should be construed accordingly."); *accord Riley*, 292 F.3d at 1342. For this reason, the Eleventh Circuit in *Riley* noted:

---

7. *See also, e.g., Winne v. Equitable Life Assurance Soc. of the United States*, 315 F. Supp. 2d 404, 411-12 (S.D.N.Y. 2003); *Araujo v. John Hancock Life Ins. Co.*, 206 F. Supp. 2d 377, 382 (E.D.N.Y. 2002); *Spielman v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, No. 01 Civ. 3013, 2001 WL 1182927, at *2-3 (S.D.N.Y. Oct. 9, 2001). *But see Shaw v. Charles Schwab & Co.*, 128 F. Supp. 2d 1270, 1273-74 (C.D. Cal. 2001) (declining to apply Supreme Court's flexible reading of "in connection with" requirement in § 10(b) in interpreting SLUSA because the statutes have different purposes).

> In enacting SLUSA, . . . Congress was not writing on a blank slate; instead, it was legislating in an area that had engendered tremendous amounts of litigation and received substantial judicial attention. In using the phrase "in connection with the purchase or sale of a covered security," Congress was not creating language from a vacuum; instead, it was using language that, at the time of SLUSA's enactment, had acquired settled, and widely-acknowledged, meaning in the field of securities law, through years of judicial construction in the context of § 10b-5 lawsuits. Under these circumstances, we must presume that Congress intended the phrase "in connection with the purchase or sale of a covered security" to have the same meaning in SLUSA that it has in § 10b-5.

292 F.3d at 1342-43.

We agree in full with this reasoning. "When . . . judicial interpretations have settled the meaning of an existing statutory provision, repetition of the same language in a new statute indicates, as a general matter, the intent to incorporate its . . . judicial interpretations as well." *Bragdon v. Abbott*, 524 U.S. 624, 645 (1998); *see also Lorillard v. Pons*, 434 U.S. 575, 581 (1978) ( "[W]here . . . Congress adopts a new law incorporating sections of a prior law, Congress normally can be presumed to have had knowledge of the interpretation given to the incorporated law, at least insofar as it affects the new statute."); *Strom v. Goldman, Sachs & Co.*, 202 F.3d 138, 147 (2d Cir. 1999) ("Congress is presumed . . . to be aware of prior judicial interpretations of similar statutory

provisions."). Nothing in SLUSA's text or legislative history evinces a congressional intent to overcome this presumption. On the contrary, the application of this jurisprudence to the language as repeated in SLUSA comports with Congress's stated goal in enacting SLUSA of closing the "federal flight loophole" by stemming the migration of claims from federal to state court. *See* SLUSA § 2, 112 Stat. at 3227 (finding that "a number of securities class action lawsuits have shifted from Federal to State courts" and reciting that SLUSA aims to "prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the [PSLRA]"); *accord Lander*, 251 F.3d at 107-08. If the "in connection with" phrase is read to reach the same conduct under SLUSA as it does under § 10(b) and Rule 10b-5, then SLUSA will preempt precisely those state class actions which could be brought as federal actions subject to the heightened requirements of the PSLRA. If it were otherwise, actions might be preempted for meeting all of SLUSA's requirements, including the "in connection with" term, but not be capable of being brought under federal law for failure to meet the parallel requirement of Rule 10b-5, a result that the legislative history does not suggest Congress intended to produce in enacting SLUSA.[8]

8. Judge Newman, concurring separately in *Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 332 F.3d 116 (2d Cir. 2003), observed that the phrase operates somewhat differently in SLUSA than in the context of actions brought under § 10(b) and Rule 10b-5. Under § 10(b) and Rule 10b-5, a plaintiff must prove that the fraud was "*actually* 'in connection with' the purchase or sale of a security, whereas under SLUSA, a defendant is required to show only that the *plaintiff has alleged* fraud 'in connection with' the purchase or sale of a security." 332 F.3d at 133 n.5 (Newman, J., concurring). Further,

(Cont'd)

**B. The Meaning of "In Connection With" a Purchase or Sale of Securities Under § 10(b) and Rule 10b-5**

Long ago the Supreme Court instructed that the "in connection with" language in § 10(b) and Rule 10b-5 "must be read flexibly, not technically and restrictively" so that "novel" and "atypical" as well as "garden type variety" frauds do not escape its prohibitive scope. *Superintendent of Ins.*, 404 U.S. at 11 n.7 (1971); *see also SEC v. Zandford*, 535 U.S. 813, 819 (2002) (holding that § 10(b) should be "construed not technically and restrictively, but flexibly to effectuate its remedial purposes" (internal quotation and citation omitted)); *Steiner v. Ames Dep't Stores, Inc. (In re Ames Dep't Stores Inc. Stock Litig.)*, 991 F.2d 953, 964 (2d Cir. 1993). Our cases have accordingly given an "expansive[ ]" construction to the "in connection with" requirement. *United States v. Russo*, 74 F.3d 1383, 1392 (2d Cir. 1996).

---

(Cont'd)

Judge Newman noted that there are at least three procedural differences: First, the roles of the parties are reversed because the defendant invoking SLUSA preemption argues that the "in connection with" condition is satisfied while the plaintiff argues that it is not. Second, under SLUSA the district court must definitively resolve that question at the beginning of the case as part of its jurisdictional inquiry. Third, because the result of SLUSA preemption may be remand to state court, unreviewable under 28 U.S.C. § 1447(d), the availability of appellate review depends on the result of the "in connection with" inquiry. *Id.* at 133. None of these procedural differences compels a different interpretation of the substantive reach of the phrase "in connection with" under SLUSA.

The reach of the "in connection with" phrase, while broad, is of course not unlimited. "[T]he incidental involvement of securities d[oes] not implicate the anti-fraud provisions of the federal securities laws." *Pross v. Katz*, 784 F.2d 455, 459 (2d Cir. 1986) (citing *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir. 1984)). The fraud must be "integral to the purchase and sale of the securities in question." *Id.* at 459; *see also Falkowski*, 309 F.3d at 1131 (holding that the fraud and stock sale must be "more than some tangential relation"). *Zandford*, the Supreme Court's most recent elaboration of the "in connection with" requirement, cautions that the phrase must not "be construed so broadly as to convert every common-law fraud that happens to involve securities into a violation of § 10(b)." 535 U.S. at 820. In that case the Court held that a deceptive practice may be "in connection with" a securities transaction if it "coincide[s]" with the transaction, even where the fraud does not relate to the value of any particular investment vehicle. *Id.* Thus, while the Court held that a broker's fraudulent scheme of selling his clients' securities for his own benefit satisfied the "in connection with" requirement even though the fraud did not relate to the investment value of a security, the Court also noted in dicta that fraud unattached to any particular purchase or sale—such as outright embezzlement from the client's account—would not. *Id.* at 820, 825 n.4.

The question of whether a given fraud arises "in connection with the purchase or sale" of a security so as to give rise to a private action for damages is subject to an important procedural limitation as well. While the SEC or the United States may bring an enforcement action under the

Rule so long as "*someone* buy[s] or sell[s] the security during the period of allegedly fraudulent conduct," 8 Louis Loss & Joel Seligman, *Securities Regulation* 3721 (3d ed. 2004), private litigants may only bring an action under Rule 10b-5 when they are themselves purchasers or sellers of the securities in question. First announced in Judge Augustus Hand's seminal decision in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 463-64 (2d Cir. 1952), this rule of standing gained wide acceptance throughout the lower federal courts; the Supreme Court ultimately ratified it in *Blue Chip*, 421 U.S. at 754-55.

In *Blue Chip*, a putative class of offerees of shares in a newly reorganized company sued under § 10(b) and Rule 10b-5 on the basis that the prospectus distributed in association with the offering was overly pessimistic. *See id.* at 726. The complaint alleged that the defendants had issued an intentionally and misleadingly sour prospectus to discourage purchases by the alleged class of offerees so that the rejected shares could then be sold at a premium to the public. *Id.* at 726- 27. After noting Congress's failure to adopt proposed amendments that would have made § 10(b) applicable to "attempts" to purchase or sell securities, the Court noted that "the longstanding acceptance [of the standing rule] by the courts" and Congress's "failure to reject *Birnbaum* 's reasonable interpretation of the wording of § 10(b)" provided persuasive justification to affirm the *Birnbaum* rule and to restrict the 10b-5 remedy to actual purchasers and sellers of securities. *Id.* at 733. Because private securities fraud actions were a creature of judicial implication and "[n]either Congress . . . [n]or the Securities and Exchange Commission . . . foreordained the present state

of the law with respect to Rule 10b-5," the Court found it proper to take policy considerations into account in determining the propriety of the standing rule. *Id.* at 737. Among the policy justifications for the rule was the concern that without it, "the door w[ould] be open to recovery of substantial damages on the part of one who offers only his own testimony" to prove that the defendant's fraud caused him, as the case might be, to fail to purchase or to fail to sell the security in question. *Id.* at 746. In contrast, imposition of the purchaser-seller rule would restrict recovery to those who could prove the "objectively demonstrable fact" of actual purchase or sale and would prevent vexatious lawsuits supported only by plaintiffs' self-serving testimony. *Id.* at 747. Such lawsuits were *ipso facto* likely to survive summary judgment and therefore to exact an "*in terrorem* . . . settlement" out of proportion to their likely merit. *Id.* at 741. The Court acknowledged that the standing rule was "an arbitrary restriction which unreasonably prevents some deserving plaintiffs from recovering damages which have in fact been caused by violations of Rule 10b-5." *Id.* at 738, 95 S.Ct. 1917; *see also id.* at 743 ("The *Birnbaum* rule undoubtedly excludes plaintiffs who have in fact been damaged by violations of Rule 10b-5, and to that extent it is undesirable."). But the Court noted that "this disadvantage is attenuated to the extent that remedies are available to nonpurchasers and nonsellers under state law." *Id.* at 738 n.9.

This Court and others have applied the *Blue Chip* purchaser-seller rule of standing to bar claims alleging fraudulently induced retention or delayed sales of securities. *See, e.g., Abrahamson v. Fleschner*, 568 F.2d 862, 868 (2d Cir. 1977) (rejecting 10b-5 "holding" claims where plaintiffs fraudulently induced not to sell their securities),

*disapproved on other grounds*, *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*, 444 U.S. 11 (1979); *see also Gurley v. Documation Inc.*, 674 F.2d 253, 256-57 (4th Cir. 1982) (recognizing that literal application of *Blue Chip* does not foreclose a claim that the fraud caused a plaintiff to sell later than he otherwise would, but concluding that "the policies underlying the *Blue Chip* decision persuade[ ] us that one who claims that he was fraudulently induced to delay a sale of securities must, like a nonseller, be denied standing under § 10(b)"), *abrogated in part on other grounds by Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 361 (1991); *O'Brien v. Cont'l Illinois Nat. Bank & Trust Co. of Chicago*, 593 F.2d 54, 58 (7th Cir. 1979).

### C. Application of the *Blue Chip* Rule to SLUSA

Although, as noted above, the parties and the SEC are in general agreement that the meaning of SLUSA's "in connection with" requirement is the same as under § 10(b) and Rule 10b-5, the parties dispute the applicability of the purchaser-seller rule of standing as a substantive limit on the preemptive reach of that phrase as used in SLUSA. Merrill Lynch contends that the standing rule is irrelevant to whether a claim is preempted by SLUSA. The SEC joins in Merrill Lynch's position. Alternatively, Merrill Lynch argues that even supposing that the rule applies, SLUSA's "in connection with" requirement has been satisfied in both of the instant cases because plaintiffs' claims include allegations of actual purchases. In opposition, plaintiffs claim that *Blue Chip's* purchaser-seller rule applies to "in connection with" under SLUSA and that because they do not seek damages based upon any actual purchases or sales of securities, preemption is inappropriate here.

*Appendix A*

As discussed below, we find defendants' and the SEC's position concerning the applicability of *Blue Chip's* purchaser-seller rule unpersuasive. Congress employed language with a settled judicial interpretation of which *Blue Chip* was a part and we see no clear indication either in the text or the legislative history of SLUSA of a congressional intent to abolish nonpurchaser and nonseller state class action claims.[9] We do not, however, fully agree with plaintiffs' contentions that their actions cannot be read as alleging a purchase or sale of securities in connection with the alleged fraud.

Merrill Lynch and the SEC argue first that because the *Blue Chip* rule is a judicially-crafted rule of standing for a private litigant to maintain an action under § 10(b) and Rule 10b-5, and not an aspect of the substantive fraud prohibition itself, the rule should not be regarded as a limit on the meaning of the "in connection with" phrase and therefore on SLUSA's preemptive scope. The limitation on standing to bring private suit for damages for fraud in connection with the purchase or sale of securities is unquestionably a distinct concept from the general statutory and regulatory prohibition on fraud in connection with the purchase or sale of securities. *Ontario Pub. Serv. Employees Union Pension Trust Fund v. Nortel Networks Corp.*, 369 F.3d 27, 34 (2d Cir. 2004) (observing that "the issue of standing" should not be conflated "with the question of whether the 'in connection with' requirement ha[s] been met"); *see also Blue Chip*, 421

9. Here again, as discussed *supra* note 6, we give the SEC's opinion as much deference as "the ultimate persuasiveness of its argument [ ]" demands, *Cmty. Health Ctr.*, 311 F.3d at 138, but do not defer to its view under *Chevron*.

U.S. at 751 n.14 (noting that even where a private party does not have standing to bring an action under Rule 10b-5, the SEC may bring an enforcement action that satisfies the "in connection with" requirement); *SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1364 (9th Cir. 1993) ("[R]estrictions on who may invoke the power of the federal judiciary to enforce the securities laws by collecting damages do not bear on the determination of whether a violation of the securities laws has been committed."). That observation, however, has little persuasive force in this context, because SLUSA deals with precisely the category of actions subject to the purchaser-seller rule. Once it is agreed that Congress deliberately borrowed SLUSA's "in connection with" language from § 10(b), the fact that the standing rule is analytically distinct from the underlying prohibition on fraud does not compel the conclusion that SLUSA preempts more than the purchaser/seller category of private damages claims over which the "in connection with" source language operates. Because *only* purchasers and sellers have a federal private damages remedy, it is far more natural to suppose that Congress meant to import the settled standing rule along with the "in connection with" phrase as a substantive standard. Nor are we moved by the observation that the standing rule is merely a judge-made gloss on the statute and the Rule, because private Rule 10b-5 damages actions are themselves a creature of judicial implication. *See Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 593 (1995) ("[W]e have made no pretense that it was Congress' design to provide the [private 10b-5] remedy afforded." (internal quotation omitted)); *SEC v. Materia*, 745 F.2d 197, 202 (2d Cir. 1984) ("The private right of action under that section is a judicial, rather than a legislative creation.").

Second, the SEC also argues that the policy considerations underlying SLUSA militate against application of the purchaser-seller rule. Observing that SLUSA aimed to shore up the PSLRA's remedial goal of curbing meritless strike suits, the SEC contends that it would be anomalous for Congress to have meant to carry over the purchaser-seller rule as a limiting construction of the "in connection with" language, because the effect would be to *allow* the very category of claims that the Supreme Court identified in *Blue Chip* as posing a particularly high risk of vexatious litigation. This argument has some force as a matter of policy. *See* Amanda M. Rose, *Life after SLUSA: What Is the Fate of Holding Claims?*, 69 Def. Couns. J. 455, 462 (2002) ("[T]o some degree the persistence of holding claims may undermine the goals of the [PSLRA]."). The question in interpreting ambiguous statutory language, however, is not what Congress might sensibly want to do, but what Congress did. *Cf. American Airlines, Inc. v. Wolens*, 513 U.S. 219, 238 (1995) (O'Connor, J., concurring in the judgment in part and dissenting in part) (arguing that while the majority "arrive[d] at what might be a reasonable policy judgment as to when state law actions . . . should be pre-empted if we were free to legislate it," the conclusion was not consistent with the relevant statute as previously interpreted). As noted, Congress defined SLUSA's preemptive scope by borrowing language with a settled judicial interpretation in the context of private damages actions, and such borrowing implicates the strong presumption that Congress is aware of and approves that construction. Under that construction, the Supreme Court held that the judicially-adopted bar on federal non-purchaser and non-seller claims was counterbalanced by the existence of remedies under state law. *Blue Chip*, 421 U.S. at 738 n.9;

*see also Small v. Fritz Cos., Inc.*, 65 P.3d 1255, 1261 (2003) ("[T]he high court's decision in *Blue Chip Stamps*, while recognizing policy considerations [weighing against holding claims], did not view those considerations as justification for a total denial of relief to defrauded holders; it reasoned only that the *federal* courts could deny a forum to wronged stockholders who are not sellers or buyers without unjust consequences because these stockholders retained a remedy in *state* courts."). SLUSA's wholesale importation of the language that gave rise to this balancing judgment must therefore be presumed to represent a ratification of that judgment. *Cf. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 381-82 (1982) (explaining that Congress's "comprehensive reexamination and significant amendment" of the Commodities Exchange Act coupled with its failure to abrogate a provision of the Act under which courts had implied a cause of action, "is itself evidence that Congress affirmatively intended to preserve" that implied right of action); *Calif. Public Employees' Ret. Sys. v. WorldCom, Inc.*, 368 F.3d 86, 105 & n. 17 (2d Cir. 2004) (noting, in analyzing conflict between statutes including one amended by SLUSA, the "presumption that a prior legal rule should be retained if no one in legislative deliberations even mentioned the rule or discussed any changes in the rule" and concluding that "in light of its complete silence in 1998 with respect to [the conflict there at issue], Congress did not alter [the] preexisting rule when it enacted SLUSA." (internal quotation omitted)).

"[I]n deciding if federal law pre-empts state law . . . we start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless

that was the clear and manifest purpose of Congress." *City of Milwaukee v. Illinois*, 451 U.S. 304, 316 (1981) (internal quotations omitted). Thus we will not regard a federal statute as completely preemptive of state law "absent some express statement or other clear manifestation from Congress." *Marcus v. AT&T Corp.*, 138 F.3d 46, 54 (2d Cir. 1998) (citing *Metropolitan Life Ins. Co. v. Taylor*, 481 U.S. 58, 65-68 (1987)); *see also Spielman*, 332 F.3d at 123 n.5 ("[T]he complete preemption doctrine must be applied sparingly and with great restraint."). There is no clear support in the legislative history for the conclusion that Congress intended SLUSA to preempt claims that do not satisfy the *Blue Chip* rule.

The legislative history includes some language that generally indicates a broad preemptive intent,[10] but contains no specific mention of holding claims or other non-purchaser/non-seller claims. *See* Joshua D. Ratner, *Stockholders'*

---

10. The conference report states that the purpose of SLUSA's preemptive provisions "is to prevent plaintiffs from seeking to evade the protections that Federal law provides against abusive litigation by filing suit in State, rather than in Federal, court," and further states that "consistent with the determination that Congress made in the [NSMIA] . . . , [SLUSA] establishes uniform national rules for securities class action litigation involving our national capital markets." H.R. Conf. Rep. No. 105-803, at 13, 1998 WL 703964 (footnote omitted). The joint statement of the House and Senate managers of the conference committee declares broadly that "[u]nder the legislation, class actions relating to a 'covered security' . . . alleging fraud or manipulation must be maintained pursuant to the provisions of Federal securities law, in Federal court (subject to certain exceptions)." 144 Cong. Rec. H11,020 (daily ed. Oct. 15, 1998), 1998 WL 720293.

*Holding Claim Class Actions under State Law after the Uniform Standards Act of 1998*, 68 U. Chi. L. Rev. 1035, 1059 (2001) (reviewing legislative history and suggesting that Congress may have been unaware of the existence of state law holding claims when it enacted SLUSA). In fact, to the extent the legislative history casts any light on the question, it suggests that Congress intended to preempt only those state claims that had migrated from federal court in response to the PSLRA. The statute itself explicitly states that it is intended to "prevent certain State private securities class action lawsuits alleging fraud from being *used to frustrate the objectives of the* [*PSLRA* ]." SLUSA § 2(5), 112 Stat. at 3227 (emphasis added). The conference report reiterates that the purpose of SLUSA's removal and preemption provisions "is to prevent plaintiffs from seeking to evade the protections that Federal law provides against abusive litigation by filing suit in State, *rather than in Federal*, court," H.R. Conf. Rep. No. 105-803, at 13, 1998 WL 703964 (emphasis added), suggesting that Congress understood that it was only preempting claims that could have been brought in federal court to begin with. *See also id.* at 15 (noting that "solution" to the problem of disparate state liability regimes was to "make Federal court *the exclusive venue* for most securities fraud class action litigation involving nationally traded securities") (emphasis added).

The bill's primary proponents also indicated their understanding that SLUSA was aimed at preventing circumvention of PSLRA and that it therefore targeted only those claims that were meant to be brought in federal court subject to the PSLRA's restrictions. Senator Christopher J. Dodd, one of the bill's two principal Senate sponsors, stated

that SLUSA "if enacted, will allow Congress to address this State litigation problem . . . . in a very targeted and narrow way, essentially preempting only those class actions that have recently migrated to State court, while leaving traditional State court actions and procedures solidly in place." 143 Cong. Rec. S10,477 (daily ed. Oct. 7, 1997) (statement of Sen. Dodd), 1997 WL 614735.[11] Nonpurchaser/nonseller fraud class action claims were not among the "traditional State court actions" Senator Dodd offered as examples of non-preempted claims, but he reiterated that "[t]his legislation has been carefully crafted only to affect those types of class actions that *are appropriately heard on the Federal level.*" *Id.* (emphasis added). In addition, Representative Thomas J. Bliley, one of the House managers of the legislation, introduced the managers' joint explanatory statement accompanying the conference report by commenting, among other things, that "[i]f there is intentional fraud, there is nothing in this legislation or in the [PSLRA] to prevent those cases from proceeding." 144 Cong. Rec. H11,020 (daily ed. Oct. 15, 1998) (statement of Rep. Bliley), 1998 WL 720293. Rep. Bliley's statement suggests that he did not understand SLUSA to require removal of non-purchaser/non-seller class-action claims, because on that

11. Even some of the broad language of preemptive intent mentioned above lends itself to this construction: it would be odd to intend to "make Federal court the exclusive venue" for securities fraud claims that cannot be brought in federal court. H.R. Conf. Rep. 105-803 at 15. *Cf. Lander*, 251 F.3d at 110-11 (considering plaintiffs' claims that SLUSA did not intend to preempt class actions concerning variable annuities because "insurance litigation has traditionally occurred in state courts," and rejecting that argument because plaintiffs failed to demonstrate that such litigation "*always* occurred in state court" (emphasis added)).

view SLUSA would extinguish those claims for failure to satisfy the *Blue Chip* standing rule.

We have already found, in *Spielman*, that SLUSA applies only to "those state claims that fall within its clear preemptive scope, thereby confining federal question jurisdiction under this statutory regime to a subset of securities fraud cases," namely those that represent plaintiffs' flight from the burdens imposed by the PSLRA. *Spielman*, 332 F.3d at 124. Reviewing the legislative history, we discern no similarly clear intent on the part of Congress to go beyond closing this "federal flight" loophole.

We are similarly unmoved by the other arguments pressed by the SEC and Merrill Lynch. The SEC argues that it may be difficult to determine at the complaint stage whether putative classes contain actual purchasers or sellers, and that this problem is obviated by its interpretation of the statute. A finding that SLUSA is broadly preemptive of any class action implicating securities fraud is admittedly easier to administer than an interpretation that requires courts to scrutinize the pleadings with care. We are, however, "constrained by our obligation to honor the clear meaning of a statute, as revealed by its language, purpose, and history," *Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 566 (1979), and cannot permit our interpretation to be swayed by the concern that Congress has left the courts a difficult task. *Cf. Brown v. R.J. Reynolds Tobacco Co.*, 52 F.3d 524, 530 (5th Cir. 1995) ("Although we recognize the difficulties of applying [a legal test mandated by the statute in issue], . . . we are constrained by the language of the statute."). SLUSA is explicit that it is not completely preemptive of state

securities law, *see Spielman*, 332 F.3d at 123, and we cannot avoid the line-drawing issues that result.

Both Merrill Lynch and the SEC also argue that other elements necessary for maintenance of a successful action for damages under Rule 10b-5—such as scienter, reliance, loss causation and compliance with the statute of limitations—should not limit the court's construction of "in connection with" under SLUSA, and that it is therefore improper to apply the standing rule applicable to such claims as a limit on SLUSA preemption. This case does not present us with an opportunity to consider the applicability of those other Rule 10b-5 requirements to SLUSA, but supposing *arguendo* that they do not apply, we reject the asserted analogy. SLUSA, as we have repeatedly noted, was intended to bolster the PSLRA, which in turn was intended to toughen the requirements for maintenance of a successful action under Rule 10b-5. We need not and do not reach the question, but see no contradiction in concluding that Congress could have intended to preempt state law securities fraud actions that if brought under federal law would fail for proof of loss causation or lack of timely filing, but did not intend to preempt a category of actions that, because of the nature of the injury alleged, could never have constituted a potential federal action.

In sum, we hold that in enacting SLUSA Congress sought only to ensure that class actions brought by plaintiffs who satisfy the *Blue Chip* purchaser-seller rule are subject to the federal securities laws. We note that this holding aligns us with every circuit court that has considered the question thus

far. *See Riley*, 292 F.3d at 1343-45 (11th Cir. ) (holding that under *Blue Chip*, SLUSA does not apply to claims dealing solely with the retention of securities rather than with their purchase or sale); *Falkowski*, 309 F.3d at 1130-31 (9th Cir. ) (concluding, in determining whether claim is preempted by SLUSA, that *Blue Chip* purchaser-seller rule is satisfied); *Green*, 279 F.3d at 598 (8th Cir.) (interpreting *Blue Chip* to mean that "nonsellers and nonpurchasers of securities are not covered by SLUSA's preemption provision").[12] Given our conclusion that to be preempted, an action must allege a purchase or sale of covered securities made by the plaintiff or members of the alleged class, we analyze each of the plaintiffs' claims to determine whether the actions before us satisfy SLUSA's conditions for preemption.

---

12. Merrill Lynch urges us to read *Professional Management Associates, Inc. Employees' Profit Sharing Plan v. KPMG LLP*, 335 F.3d 800 (8th Cir. 2003), as rejecting the view that the *Blue Chip* purchaser-seller requirement applies to SLUSA. The case does not go so far. The plaintiffs in *Professional Management* alleged that they "*bought* and retained their . . . shares" in reliance on the relevant misrepresentation. *Id.* at 802 (emphasis added). The court held that in light of their allegation of a purchase in reliance on the fraud, the plaintiffs could not "avoid preemption by . . . claiming [only] damages suffered as a result of holding its stock." *Id.* at 803. This ruling flows naturally from SLUSA, which bars claims "alleging" fraud in connection with purchase or sale, and is consistent with the Eighth Circuit's earlier holding in *Green* that the purchaser-seller rule applies. *Green*, 279 F.3d at 598.

*Appendix A*

**3. The parties' claims**

**A. Dabit**

Dabit asserts claims for two types of damages: (i) "holding" damages related to Merrill Lynch's fraudulent inducement of Dabit to retain certain securities and (ii) commissions that Dabit would have earned from clients that he lost as a result of Merrill Lynch's alleged fraud. Despite our application of the *Blue Chip* purchaser-seller rule, we conclude that Dabit's "holding" class as defined includes purchasers and thus that the putative class action includes allegations triggering SLUSA preemption.

A claim that a plaintiff purchased stock independent of any misrepresentation but was induced to retain it by a material misrepresentation or omission does not satisfy the *Blue Chip* standing requirement integral to the "in connection with" requirement of Rule 10b-5. *See Abrahamson*, 568 F.2d at 868. Other circuits have already concluded, at least in dicta, that SLUSA does not generally preempt such holding claims. *See Riley*, 292 F.3d at 1345 (noting that "under *Blue Chip*, SLUSA does *not* apply to claims dealing *solely* with the retention of securities, rather than with purchase or sale," but concluding that the plaintiff had failed to allege such a claim); *Green*, 279 F.3d at 599 (suggesting that a plaintiff could avoid SLUSA preemption "so long as his state-law claim does not require him to prove there was a sale or purchase of a covered security in reliance on the misrepresentation"); *cf. Falkowski*, 309 F.3d at 1131

(approving analysis in *Riley* and *Green* ).[13] Our determination that the *Blue Chip* rule operates as a limit on the preemptive scope of SLUSA similarly commits us to the view that such holding claims are not preempted.[14]

When a plaintiff alleges that he purchased *and* retained stocks in reliance on a misrepresentation or omission of the defendant, however, the claim satisfies the *Blue Chip* rule and plainly falls within SLUSA's prohibition on state law claims "alleging . . . a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1). In *Riley*, the Eleventh Circuit held that "when a claim that sweeps within

---

13. *See also, e.g., Cape Ann Investors LLC v. Lepone*, 296 F. Supp. 2d 4, 11 (D. Mass. 2003); *Dacey v. Morgan Stanley Dean Witter & Co.*, 263 F. Supp. 2d 706, 711-12 (S.D.N.Y. 2003); *Shen v. Bohan*, 2002 WL 31962136, at *3-4 (C.D. Cal. Oct. 17, 2002); *Korsinsky v. Salomon Smith Barney Inc.*, 2002 WL 27775, at *6 (S.D.N.Y. Jan. 10, 2002); *Hardy v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 189 F. Supp. 2d 14, 18 (S.D.N.Y. 2001); *Shaev v. Claflin*, No. C 01-0009, 2001 WL 548567, at *5 (N.D. Cal. May 17, 2001); *Gutierrez v. Deloitte & Touche, LLP*, 147 F. Supp. 2d 584, 594-95 (W.D. Tex. 2001); *Gordon v. Buntrock*, No. 00-CV-303, 2000 WL 556763, *4 (N.D. Ill. Apr. 28, 2000).

14. States have diverged in their receptivity to such claims. *See Greenfield v. Fritz Cos., Inc.*, 98 Cal. Rptr. 2d 530, 538-39 & n.5 (Cal. Ct. App. 2000) (listing jurisdictions permitting "holding"-type claims and noting that Connecticut does not), *rev'd on other grounds sub nom. also Small v. Fritz Cos., Inc.*, 65 P.3d 1255, 1261 (2003). We do not have to determine whether Oklahoma law would permit recovery on such a theory, but only whether the putative state law claim falls within SLUSA's preemptive scope.

its ambit actual purchases or sales of stock *is* covered by SLUSA, a plaintiff may not avoid SLUSA's restrictions simply by alleging that a given misrepresentation caused him *both* to purchase and [to] hold a particular security." 292 F.3d at 1345. If it were otherwise, a plaintiff who is perfectly capable of pleading a claim under Rule 10b-5 could defeat SLUSA preemption (and thus evade the heightened requirements of the PSLRA) merely by alleging what is almost invariably true—that the misrepresentation which caused him to purchase the stock also caused him to retain it for some period of time. *See Riley*, 292 F.3d at 1345 ("[A]ll investors, by definition, hold their shares for at least some time after purchase.").

Moreover, a plaintiff who alleges the purchase and retention of securities in reliance on the misrepresentation but who forswears *damages* from the purchase and seeks only "holding damages" has still run afoul of SLUSA, which by its plain terms preempts claims "alleging" fraud in connection with the purchase or sale, and not merely claims seeking damages specifically traceable to the initial purchase. 15 U.S.C. § 78bb(f)(1); *see Prof'l Mgmt.*, 335 F.3d at 803 (holding that plaintiff "cannot avoid preemption by asserting it is only claiming damages suffered as a result of holding its stock" because "SLUSA's 'in connection with' requirement . . . is not limited to cases involving damages claimed as a result of the purchase or sale of securities [but]. . . . applies to any covered class action alleging an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security"). Grafting such a limitation onto the statute's plain terms would vitiate Congress's intent in enacting SLUSA, because plaintiffs who

have a federal remedy subject to the PSLRA's requirements could evade those requirements and bring a "strike suit" merely by purporting to forego some portion of their potential recovery. Congress forestalled such a move by prohibiting the maintenance of an action "alleging" fraud in connection with purchase or sale.

Dabit's amended complaint is generally careful to discuss only retention of a defined class of "ML stocks" during the relevant "class period." It is silent about when or how Dabit himself or any of his clients came to own any of these stocks, and charges only that Merrill Lynch made misrepresentations *subsequent* to Dabit's purchase. *See, e.g.*, Amended Compl. ¶ 2 (alleging that "ML, after Plaintiff's purchase of the ML Stocks ..., failed to advise Plaintiff of the fact of the decreasing values of the ML Stocks, and misrepresented to Plaintiff that the ML Stocks were worthy of holding in Plaintiff's or Plaintiff's clients' portfolio. . . ."). Dabit's putative class definition, however, fails to distinguish between those who came to hold an ML Stock before any relevant misrepresentation and those who purchased it in reliance on such representations. Dabit defines the class to include

> all . . . former or current account executives . . . who, while employed by [ML] . . . owned and continue to own one or more of the ML recommended securities identified in Exhibit A . . . or recommended such securities to their clients . . . and who suffered damages as a result of owning and holding such ML Stocks during th[e defined] time

> period, or who suffered damages as a consequence of the loss of clients due to ML's wrongful actions.

The class is elsewhere defined as all of those "persons who, while employed by [Merrill Lynch] as Retail Brokers, held individually or on behalf of the Classes' [sic] clients any of the ML Stocks during the period from December 1, 1999 through and including December 31, 2000 (the 'Class Period') and were damaged thereby." Damages suffered from "own[ing]" stocks during the class period include damages incurred by purchasing them during that period, and nothing in the complaint excludes such claims. The complaint elsewhere alleges that Merrill Lynch made "materially false and misleading statements" in 1999 and 2000—that is, throughout the class period—and that at least some of these false and misleading statements took the form of "buy recommendations." The two common-law causes of action incorporate all of the factual allegations in the complaint and stake the claims, respectively, on the breaches "in the manner described hereinabove" and through "[t]he wrongful acts alleged herein." Thus the complaint sweeps in the claims of brokers who purchased the stock during the class period in reliance on the misrepresentations and were damaged thereby.

Because the purchase of a stock in reliance on a misleading or fraudulent "buy" recommendation regarding the quality of that stock clearly satisfies the "in connection with" requirement as that phrase has been interpreted in the 10b-5 context, *see In re Ames Dept. Stores Inc. Stock Litigation*, 991 F.2d at 967; *Korsinsky*, 2002 WL 27775, at *5, the class as defined by Dabit includes those with preempted claims of purchase and retention. Lower courts

have diverged in their approach to complaints that do not *specifically* allege purchases in reliance on the misrepresentation but that define the class to include members with SLUSA-preempted claims, with results that are difficult to reconcile.[15] While we must read SLUSA's preemptive provisions narrowly to avoid interference with state police powers that Congress did not clearly intend, we must also give meaningful effect to SLUSA's remedial goals with respect to the class of purchaser/seller claims that *are* clearly preempted. *See Spielman*, 332 F.3d at 123 & n.5, 124. Where, as here, the complaint does not include sufficient information to permit the court to identify and separate preempted and non-preempted subclasses, we believe that the proper approach will ordinarily be to dismiss the entire

---

15. *Compare. e.g., Shaev*, 2001 WL 548567 at *6 (holding that complaint that is "devoid of any allegations that make . . . a connection" between misleading conduct and purchase of stock escapes SLUSA preemption because "complaint does not indicate that the purported class chose to become ... shareholders based on any misrepresentations or omissions") *and Gutierrez*, 147 F. Supp. 2d at 594 *with Cape Ann Investors*, 296 F. Supp. 2d at 12 & n.6 (holding that complaint that offers no means of distinguishing those who purchased in reliance on misrepresentation from those who merely held is SLUSA preempted and noting that "[i]f a class representative could give purchasers and sellers a free ride by salting into the class a member or two with holding claims, it would be a rare case in which SLUSA applied at all") *and Korsinsky*, 2002 WL 27775, at *5 (finding that complaint defining class to include those who purchased subsequent to misleading "buy" recommendation was SLUSA preempted); *and Hardy*, 189 F. Supp. 2d at 18 (finding that complaint including class definition that "makes no effort to distinguish between customers who purchased before and after the stock rating allegedly became inaccurate" is preempted under SLUSA).

claim pursuant to SLUSA. Given the close relationship in most instances between a holding claim and the purchase of securities, and given SLUSA's manifest intent to preempt state-law claims alleging fraud in connection with an actual purchase, it is sensible to require a would-be "holding" lead plaintiff expressly to exclude from the class claimants who purchased in connection with the fraud and who therefore could meet the standing requirement for maintenance of a 10b-5 action. *See, e.g., Gordon*, 2000 WL 556763, at *3 (holding that holding class claim was not SLUSA-preempted because "plaintiff has gone to great lengths to stress that his complaint alleges misrepresentations *only* in the holding of securities" and complaint stated that as of the date on which *all* class members had already purchased stock, it was fairly valued and no class member had been deceived into holding the stock).

We therefore hold that when the class definition includes persons with SLUSA-preempted claims and does not permit the court to distinguish any non-preempted subclass, SLUSA requires that the claim be dismissed. Ordinarily such dismissal should be without prejudice in order to allow the plaintiff to plead a claim sounding only in state law if possible. We accordingly reverse so much of the district court's order as dismissed Dabit's and the putative class's claims for damages resulting from the owning and retention of the ML stocks and remand the case with instructions to dismiss those claims without prejudice.

Dabit's claim regarding commissions lost when customers abandoned Merrill Lynch following disclosure of its improper practices fares better. This claim, brought on

behalf of a putative class of brokers who "recommended [the defined ML stocks] to their clients" during the relevant class period and who "suffered damages as a consequence of the loss of clients due to ML's wrongful actions," relies not on the purchase or sale of any security in connection with the fraud, but on the absence of any such transactions by clients of the class members after the fraud was disclosed. Although we have not discovered another case discussing the effect of SLUSA on this apparently novel theory of recovery and express no opinion regarding its underlying merit,[16] it is clear that such a claim, by its very nature, does not allege fraud that "coincide[s]" with the sale or purchase of a security. *Zandford*, 535 U.S. at 825. It is therefore not preempted by SLUSA.

SLUSA prohibits the "maint[enance] in any State or Federal court" of any "covered class action" alleging fraud in the purchase or sale of a covered security under state law, 15 U.S.C. § 78bb(f)(1), and defines a "covered class action" as a "single lawsuit" or "group of lawsuits" brought on behalf of more than fifty persons and meeting other specified criteria, 15 U.S.C. § 78bb(f)(5)(B). These provisions might be read to suggest that where a single complaint contains claims that include allegations triggering preemption and other claims that do not, SLUSA prohibits maintenance of the entire action. On this reading, SLUSA would effectively preempt any state law claim conjoined in a given case with a securities fraud claim, whatever its nature. We assume,

16. As noted *supra* note 14, in considering whether a claim is preempted by SLUSA we do not consider the merit of the claim under state law. We therefore express no view on whether Oklahoma law would permit recovery on this theory.

however, that the historic police powers of the states are not preempted unless it was Congress's "clear and manifest purpose" to do so. *City of Milwaukee*, 451 U.S. at 316 (internal quotation omitted). Thus we decline to read SLUSA as such an imprecise instrument. *See, e.g.*, *Falkowski*, 309 F.3d at 1131-32 (affirming dismissal of preempted fraud claims but permitting maintenance of remaining contract claims). As we have already noted, SLUSA's language and legislative history indicate no intent to preempt categories of state action that do not represent "federal flight" litigation. We therefore reverse so much of the district court's order as dismissed the lost commissions claim and remand it for further proceedings.

**B. IJG**

IJG defined its putative class to include "[a]ll persons or entities who maintained retail brokerage accounts with [Merrill Lynch], and who paid a commission or fees to [Merrill Lynch]," and seeks to recover damages caused by the payment of those fees and commissions in contract and under Minnesota consumer protection law. Like Dabit, IJG studiously avoids any specific allegation of a purchase or sale of security in reliance on the biased research that it received. IJG argues that SLUSA's "in connection with" requirement is not satisfied because its claims relate solely to the contractual obligations and statutory and common-law duties owed by Merrill Lynch to its retail customers and thus "do not arise out of the purchase and sale of securities of companies that Merrill [Lynch] researched, but from the

purchase and sale of Merrill[ Lynch]'s objectivity."[17] The objectivity that IJG claims it believed it was purchasing, however, was objectivity with respect to investment recommendations. The alleged breach of contract and violation of consumer protection statutes consisted of the provision of biased and misleading advice notwithstanding this alleged promise. We hold that, while the claims for flat annual fees are not preempted by SLUSA, the claims for commissions paid to Merrill Lynch are preempted because they necessarily involve allegations of a purchase or sale of securities "in connection with" this alleged misconduct.

In reaching this conclusion, we are guided generally by the analyses of some of our sister circuits. In *Behlen v. Merrill Lynch*, 311 F.3d 1087 (11th Cir. 2002), the Eleventh Circuit found that a plaintiff's claims were preempted by SLUSA where the object of the alleged fraud was to cause investment in inappropriate securities to which higher fees attached and the complaint requested damages for investments made in reliance on that advice. *Id.* at 1093-94. Under those circumstances, the fees and commissions paid were held to be "an integral part of the [underlying] transactions."

17. IJG also argues that its contract claim is not preempted because it does not allege any misrepresentation, omission, or deceptive device or practice in connection with that claim. This is plainly not the case, since the complaint alleges that the breach of contract consisted of the provision of "biased advice" regarding investments. The statutory claims explicitly allege misrepresentations regarding the objectivity of Merrill Lynch's advice; these alleged promises of objectivity, in turn, are only rendered misleading by the complaint's further allegation that Merrill Lynch produced and delivered biased research. This prerequisite for SLUSA preemption is therefore satisfied as to all of IJG's claims.

*Id.* at 1094. In *Dudek v. Prudential Securities, Inc.*, 295 F.3d 875 (8th Cir. 2002), the Eighth Circuit analogously found the plaintiffs' claims preempted where they alleged that the "defendants' misconduct caused plaintiffs to invest in inappropriate securities" and therefore to pay higher fees and incidental costs than necessary. *Id.* at 878. In contrast, in *Green*, the Eighth Circuit reached the opposite conclusion regarding SLUSA preemption where the plaintiff sought to recover flat fees paid for real-time online stock quotes that were in fact several hours old and "nothing in [plaintiff's] . . . complaint suggest[ed] that his cause of action ar[ose] from a sale or purchase of a security in reliance on information gained from [defendant's] real-time quote service." *Green*, 279 F.3d at 598-99. These cases suggest a logical distinction between claims that turn on injuries caused by acting on misleading investment advice, which (except in the case of holding or nonpurchase claims) necessarily allege a purchase or sale, and claims which merely allege that the plaintiff was injured by paying, independent of any given transaction, for a service that the broker failed to provide.

Consistent with this analysis, a few lower courts have analyzed claims similar to IJG's and have found that SLUSA preemption turns on whether some or all of the moneys paid for fraudulent or misleading advice were in the form of commissions tied to particular securities transactions. *See Rowinski v. Salomon Smith Barney, Inc.*, No. 3:02-CV-2014, 2003 WL 22740976, at *3 n.5 (M.D. Pa. Nov. 20, 2003) (distinguishing claim for flat monthly fee in *Green* from case at bar that sought commission fees, which were incurred only upon purchases or sales of securities and which claims the

court held were preempted); *McCullagh v. Merrill Lynch & Co.*, No. 01 Civ. 7322, 2002 WL 362774, at *4 (S.D.N.Y. Mar. 6, 2002) (finding preemption appropriate because even though "[p]laintiffs do not allege the purchase of specific stocks based on the recommendations, their allegations are clearly about the purchase of stocks because they seek disgorgement of commissions paid to [defendant]"); *see also Shaw v. Charles Schwab & Co.*, 2003 WL 1463842, at *4 (Cal. Sup. Ct. Mar. 7, 2003) (finding SLUSA dismissal appropriate where claim concerning defendant's alleged overcharging of commissions was necessarily dependent on underlying securities transactions because purchases and sales of securities triggered commissions in dispute). We find this logic compelling. The commissions giving rise to the claimed breach of contract and violations of the state consumer fraud laws only accrued when plaintiffs purchased or sold securities through Merrill Lynch. The claims for commissions therefore necessarily allege misstatements or omissions in connection with the purchase and sale of securities, and are preempted. *See Zandford*, 535 U.S. at 820, 825 (finding Rule 10b-5's "in connection with" requirement satisfied when "the securities transactions and breaches [complained of] . . . coincide[d]" and "were not independent events.").[18]

---

18. In support of its claim IJG cites to the district court decision in *Spielman v. Merrill Lynch, Pierce, Fenner, & Smith Inc.*, No. 01-CV-3013, 2001 WL 1182927 (S.D.N.Y. Oct. 9, 2001), *appeal dismissed on other grounds*, 332 F.3d 116 (2d Cir. 2003), and to *Gray v. Seaboard Sec., Inc.*, 241 F. Supp. 2d 213 (N.D.N.Y. 2003). Those cases, however, are not helpful to IJG. In *Spielman*, the district court found that the transaction fees sought were not preempted by SLUSA because the alleged fraud concerned the commission structure itself, not the investment quality of securities. 2001 WL 1182927, at

(Cont'd)

*Appendix A*

The claims for the return of annual fees for unbiased research do, however, withstand SLUSA. An annual fee for services is paid whether or not the customer transacts on the account, and the misrepresentations inherent in the alleged nonperformance and statutory violations therefore do not necessarily "coincide[ ] with" a securities transaction, *Zandford*, 535 U.S. at 820; *compare Green*, 279 F.3d at 598 (finding no SLUSA preemption where plaintiff "allege[d] no sale or purchase of a covered security, only that he did not receive the type of information from [defendant] for which he believed he had contracted and paid twenty dollars monthly") *with Rowinski*, 2003 WL 22740976, at *3 n.5 (distinguishing claim for flat monthly fee in *Green* from case at bar that sought commission fees incurred only upon purchases or sales of securities).[19]

(Cont'd)

*4-5. That holding is suspect after *Zandford*, which held that Rule 10b-5 reaches misrepresentations that "coincide [ ]" with securities transactions whether or not they relate to the quality of any particular security, 535 U.S. at 820, but in any event it is quite different from the case at bar, where the plaintiffs implicitly allege that they transacted in securities and were thereupon charged for biased investment advice. Such allegations fall squarely within SLUSA's reach. In *Gray*, the court found that plaintiffs had alleged that defendants misrepresented the source of their investment advice, 241 F. Supp. 2d at 220, and further found that their breach of contract claim did not require them to allege any misrepresentation or omission, *id.* at 221. Here, in contrast, IJG alleges that the breach of contract and the statutory violations consisted precisely of the provision of misleading investment advice.

19. The SEC argues in its amicus brief that even annual fees claimed as damages, such as IJG's, should be preempted by SLUSA.

(Cont'd)

*Appendix A*

Neither the breach of contract claim nor the statutory claims for the return of these fees necessarily rest on any allegation

---

(Cont'd)

The SEC's argument in this regard stems from its broader contention that "the 'in connection with the purchase or sale of' securities requirement is satisfied when a broker-dealer makes a misrepresentation or omission to a customer that relates to the customer's brokerage account regardless of whether the deception coincides with, or could be expected to influence, a securities transaction." Brief of the SEC, at 11. Although the meaning of the "in connection with" phrase under Rule 10b-5 itself is a subject on which we owe the views of the SEC *Chevron* deference, *Zandford*, 535 U.S. at 819-20, we are unable to regard this view as a reasonable construction of the Rule. *See Mead*, 533 U.S. at 229 (under *Chevron*, court is "obliged to accept the agency's position if . . . reasonable"); *Daniel*, 439 U.S. at 566 n.20 (noting that "[o]n . . . occasion[ ] . . . this Court has found it necessary to reject the SEC's [unreasonable] interpretation of various provisions of the Securities Acts."). On this view, the scope of the "in connection with" language is essentially unlimited, reaching even misrepresentations and omissions regarding an account that do not coincide with and have nothing to do with a securities transaction. In *Zandford*, the Supreme Court noted that its holding that the misrepresentation need not relate to the value of a security "does not transform every breach of fiduciary duty into a federal securities violation" and gave as one example of a claim that would not satisfy Rule 10b-5 embezzlement of funds from a client's account. *Zandford*, 535 U.S. at 825 n.4. The SEC's view is impossible to square with this uncontradicted dictum, and appears to be a more expansive reading than the view to which the Court deferred as reasonable in *Zandford*. *See id.* at 819-20. We therefore do not defer to the SEC's related view that a misrepresentation that does not coincide with any securities transaction satisfies the "in connection with" requirement so as to trigger SLUSA preemption.

of a purchase or sale of a security.[20] *See* Minn. Stat. §§ 8.31 subd. 3a, 325D.44, 325F.68-.71; *see generally Group Health Plan, Inc. v. Phillip Morris Inc.*, 621 N.W.2d 2, 5-6, 12-15 (Minn. 2001) (discussing requirements for maintenance of private action under consumer fraud statutes including Minn. Stat. § 325F.69); *Crenlo, Inc. v. Austin-Romtech*, No. A03-851, 2004 WL 948352, *3-5 (2004) (discussing elements of breach of contract claim under Minnesota law).[21] The district court therefore erred to the extent that it held that the claims for annual fees wrongfully charged by defendants were preempted by SLUSA. Accordingly, we affirm in part the dismissal of the complaint and the denial of IJG's motion for remand, but reverse the dismissal in part and vacate the judgment in part with instructions to the district court to grant IJG's motion for remand as to so much of the claim as seeks recovery on behalf of a putative class of those who paid annual fees.

---

20. IJG's prayer for relief seeks the return of "funds wrongfully withheld, charged or retained" by Merrill Lynch as well as "actual damages including, but not limited to, attorneys fees, costs and expenses incurred in paying for valueless services." While this prayer could conceivably be read to encompass consequential damages stemming from investment losses incurred in reliance on Merrill Lynch's investment advice, that is not the most natural reading. IJG disavowed any such construction of its prayer for relief in its brief on this appeal. Plaintiffs are therefore judicially estopped from seeking any such damages on remand.

21. Again, we express no view on the viability of IJG's claims under Minnesota law.

*Appendix A*

## CONCLUSION

We hold that (i) the meaning of "in connection with the purchase or sale of a . . . security" under SLUSA is the same as under § 10(b) of the Exchange Act and Rule 10b-5, (ii) the purchaser-seller rule affirmed in *Blue Chip* applies to the construction of "in connection with" under SLUSA, and (iii) under the particular circumstances presented in these cases, the actions here contain allegations of misrepresentations "in connection with" securities transactions and are partly preempted under SLUSA. For these reasons, the judgment below is AFFIRMED in part, VACATED in part and REMANDED for further proceedings consistent with this opinion.

**APPENDIX B — OPINION AND DECISION OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK DATED APRIL 10, 2003**

**UNITED STATES DISTRICT COURT**
**SOUTHERN DISTRICT OF NEW YORK**

---

02 MDL 1484 (MP)

IN RE MERRILL LYNCH & CO., INC. RESEARCH REPORTS SECURITIES LITIGATION

---

02 CV 4051 (MP)

CICCARELLI,

Plaintiff,

v.

MERRILL LYNCH & CO., INC.,

Defendant.

---

02 CV 8472 (MP)

DABIT,

Plaintiff,

v.

MERRILL LYNCH & CO., INC.,

Defendant.

*Appendix B*

02 CV 9487 (MP)

IJG INVESTMENTS, L.P.,

Plaintiff,

v.

MERRILL LYNCH & CO., INC.,

Defendant.

---

02-CV 4205 (MP)

SMITH,

Plaintiff,

v.

MERRILL LYNCH & CO., INC.,

Defendant.

---

**OPINION AND DECISION**

Defendants have moved to dismiss the complaints pursuant to Fed. R. Civ. P. 12(b)(6) as preempted by the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 ("SLUSA") (codified as 15 U.S.C. §§ 77p & 78bb(f)).

*Appendix B*

The four actions that are the subject of the instant motion purport to eschew federal claims and instead, assert "state law" claims based on the very same alleged series of transactions and occurrences asserted in the federal securities actions currently being coordinated before this Court.

SLUSA provides that preempted causes of action may not be maintained in any state or federal court. *See* 15 U.S.C. §§ 77p(b) & 78bb(f)(1). SLUSA expressly preempts, and provides for the removal and dismissal of, any private class action seeking damages based on state statutory or common law that alleges misrepresentations or omissions of material facts or any manipulative or deceptive device or contrivance in connection with the purchase or sale of a nationally traded security.

The claims alleged in the four actions fall squarely within SLUSA's ambit.

Accordingly, the motions to dismiss all of the complaints are hereby granted and the motions to remand the *Ciccarelli*, *IJG Investments*, and *Smith* actions are denied.

So Ordered.

April 10, 2003

MILTON POLLACK
SENIOR UNITED STATES DISTRICT JUDGE

# APPENDIX C — RELEVANT STATUTES AND REGULATIONS

## 15 U.S.C. § 77p

### § 77p. Additional remedies; limitation on remedies

#### (a) Remedies additional

Except as provided in subsection (b), the rights and remedies provided by this subchapter [15 U.S.C.A. § 77a et seq.] shall be in addition to any and all other rights and remedies that may exist at law or in equity.

#### (b) Class action limitations

No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—

**(1)** an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or

**(2)** that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

#### (c) Removal of covered class actions

Any covered class action brought in any State court involving a covered security, as set forth in subsection (b), shall be removable to the Federal

district court for the district in which the action is pending, and shall be subject to subsection (b).

**(d) Preservation of certain actions**

**(1) Actions under State law of State of incorporation**

**(A) Actions preserved**

Notwithstanding subsection (b) or (c), a covered class action described in subparagraph (B) of this paragraph that is based upon the statutory or common law of the State in which the issuer is incorporated (in the case of a corporation) or organized (in the case of any other entity) may be maintained in a State or Federal court by a private party.

**(B) Permissible actions**

A covered class action is described in this subparagraph if it involves—

**(i)** the purchase or sale of securities by the issuer or an affiliate of the issuer exclusively from or to holders of equity securities of the issuer; or

**(ii)** any recommendation, position, or other communication with respect to the sale of securities of the issuer that—

**(I)** is made by or on behalf of the issuer or an affiliate of the issuer to holders of equity securities of the issuer; and

**(II)** concerns decisions of those equity holders with respect to voting their securities, acting in response to a tender or exchange offer, or exercising dissenters' or appraisal rights.

**(2) State actions**

**(A) In general**

Notwithstanding any other provision of this section, nothing in this section may be construed to preclude a State or political subdivision thereof or a State pension plan from bringing an action involving a covered security on its own behalf, or as a member of a class comprised solely of other States, political subdivisions, or State pension plans that are named plaintiffs, and that have authorized participation, in such action.

**(B) State pension plan defined**

For purposes of this paragraph, the term "State pension plan" means a pension plan established and maintained for its employees by the government of the State or political

subdivision thereof, or by any agency or instrumentality thereof.

**(3) Actions under contractual agreements between issuers and indenture trustees**

Notwithstanding subsection (b) or (c), a covered class action that seeks to enforce a contractual agreement between an issuer and an indenture trustee may be maintained in a State or Federal court by a party to the agreement or a successor to such party.

**(4) Remand of removed actions**

In an action that has been removed from a State court pursuant to subsection (c), if the Federal court determines that the action may be maintained in State court pursuant to this subsection, the Federal court shall remand such action to such State court.

**(e) Preservation of State jurisdiction**

The securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions.

**(f) Definitions**

For purposes of this section, the following definitions shall apply:

*Appendix C*

**(1) Affiliate of the issuer**

The term "affiliate of the issuer" means a person that directly or indirectly, through one or more intermediaries, controls or is controlled by or is under common control with, the issuer.

**(2) Covered class action—**

**(A) In general**

The term "covered class action" means—

**(i)** any single lawsuit in which—

**(I)** damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individual persons or members; or

**(II)** one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated, and questions of law or fact common to those persons or members of the prospective class predominate over any questions affecting only individual persons or members; or

**(ii)** any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which—

**(I)** damages are sought on behalf of more than 50 persons; and

**(II)** the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.

**(B) Exception for derivative actions**

Notwithstanding subparagraph (A), the term "covered class action" does not include an exclusively derivative action brought by one or more shareholders on behalf of a corporation.

**(C) Counting of certain class members**

For purposes of this paragraph, a corporation, investment company, pension plan, partnership, or other entity, shall be treated as one person or prospective class member, but only if the entity is not established for the purpose of participating in the action.

**(D) Rule of construction**

Nothing in this paragraph shall be construed to affect the discretion of a State court in determining whether actions filed in such court should be joined, consolidated, or otherwise allowed to proceed as a single action.

*Appendix C*

**(3) Covered security**

The term "covered security" means a security that satisfies the standards for a covered security specified in paragraph (1) or (2) of section 77r(b) of this title at the time during which it is alleged that the misrepresentation, omission, or manipulative or deceptive conduct occurred, except that such term shall not include any debt security that is exempt from registration under this subchapter pursuant to rules issued by the Commission under section 77d(2) of this title.

*Appendix C*

**15 U.S.C. § 77r(b)(1)(A)**

**(b) Covered securities**

For purposes of this section, the following are covered securities:

(1) Exclusive Federal registration of nationally traded securities

A security is a covered security if such security is—

**(A)** listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed, or authorized for listing, on the National Market System of the Nasdaq Stock Market (or any successor to such entities);

* * * *

*Appendix C*

**15 U.S.C. § 78bb(f)**

**(f) *Limitations on remedies***

(1) *Class Action Limitations.* No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging—

(A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security; or

(B) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.

(2) *Removal of Covered Class Actions.* Any covered class action brought in any State court involving a covered security, as set forth in paragraph (1), shall be removable to the Federal district court for the district in which the action is pending, and shall be subject to paragraph (1).

(3) *Preservation of Certain Actions.*

(A) *Actions Under State Law of State of Incorporation*

(i) *Actions Preserved.* Notwithstanding paragraph (1) or (2), a covered class action described in clause (ii) of this subparagraph

that is based upon the statutory or common law of the State in which the issuer is incorporated (in the case of a corporation) or organized (in the case of any other entity) may be maintained in a State or Federal court by a private party.

(ii) *Permissible Actions.* A covered class action is described in this clause if it involves—

(I) the purchase or sale of securities by the issuer or an affiliate of the issuer exclusively from or to holders of equity securities of the issuer; or

(II) any recommendation, position, or other communication with respect to the sale of securities of an issuer that—

(aa) is made by or on behalf of the issuer or an affiliate of the issuer to holders of equity securities of the issuer; and

(bb) concerns decisions of such equity holders with respect to voting their securities, acting in response to a tender or exchange offer, or exercising dissenters' or appraisal rights.

*Appendix C*

(B) *State Actions:*

(i) *In General.* Notwithstanding any other provision of this subsection, nothing in this subsection may be construed to preclude a State or political subdivision thereof or a State pension plan from bringing an action involving a covered security on its own behalf, or as a member of a class comprised solely of other States, political subdivisions, or State pension plans that are named plaintiffs, and that have authorized participation, in such action.

(ii) *State Pension Plan Defined.* For purposes of this subparagraph, the term "State pension plan" means a pension plan established and maintained for its employees by the government of a State or political subdivision thereof, or by any agency or instrumentality thereof.

(C) *Actions Under Contractual Agreements Between Issuers and Indenture Trustees.* Notwithstanding paragraph (1) or (2), a covered class action that seeks to enforce a contractual agreement between an issuer and an indenture trustee may be maintained in a State or Federal court by a party to the agreement or a successor to such party.

(D) *Remand of Removed Actions.* In an action that has been removed from a State court

pursuant to paragraph (2), if the Federal court determines that the action may be maintained in State court pursuant to this subsection, the Federal court shall remand such action to such State court.

(4) *Preservation of State Jurisdiction.* The securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions.

(5) *Definitions.* For purposes of this subsection, the following definitions shall apply:

(A) *Affiliate of the Issuer.* The term "affiliate of the issuer" means a person that directly or indirectly, through one or more intermediaries, controls or is controlled by or is under common control with, the issuer.

(B) *Covered Class Action.* The term "covered class action" means—

(i) any single lawsuit in which—

(I) damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of

individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individual persons or members; or

(II) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated, and questions of law or fact common to those persons or members of the prospective class predominate over any questions affecting only individual persons or members; or

(ii) any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which—

(I) damages are sought on behalf of more than 50 persons; and

(II) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.

(C) *Exception for Derivative Actions.* Notwithstanding subparagraph (B), the term "covered class action" does not include an exclusively derivative action brought by one or more shareholders on behalf of a corporation.

(D) *Counting of Certain Class Members.* For purposes of this paragraph, a corporation, investment company, pension plan, partnership, or other entity, shall be treated as one person or prospective class member, but only if the entity is not established for the purpose of participating in the action.

(E) *Covered Security.* The term "covered security" means a security that satisfies the standards for a covered security specified in paragraph (1) or (2) of section 18(b) of the Securities Act of 1933 [15 U.S.C.A. § 77r(b)], at the time during which it is alleged that the misrepresentation, omission, or manipulative or deceptive conduct occurred, except that such term shall not include any debt security that is exempt from registration under the Securities Act of 1933 [15 U.S.C.A. § 77a et seq.] pursuant to rules issued by the Commission under section 4(2) of that Act [15 U.S.C.A. § 77d(2)].

(F) *Rule of Construction.* Nothing in this paragraph shall be construed to affect the discretion of a State court in determining whether actions filed in such court should be joined, consolidated, or otherwise allowed to proceed as a single action.

* * * *

*Appendix C*

## 15 U.S.C. § 78j(b)

### § 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

**(b)** To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

* * * *

*Appendix C*

## 17 C.F.R. § 240.10b-5

**§ 240.10b-5 Employment of manipulative and deceptive devices.**

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

## APPENDIX D – BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION DATED JUNE, 2004

**UNITED STATES COURT OF APPEALS**
**FOR THE SECOND CIRCUIT**

03-7499, 03-7458

---

SHADI DABIT,
on behalf of himself and all others similarly situated,

Plaintiff-Appellant.

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Defendant-Appellee.

---

IJG INVESTMENTS L.P. and IRLYS GUY,
on behalf of themselves and all others similarly situated,

Plaintiffs-Appellants,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Defendant-Appellee.

---

On Appeal from the United States District Court
for the Southern District of New York

---

**BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, *AMICUS CURIAE*, ON ISSUES ADDRESSED**

---

*Appendix D*

GIOVANNI P. PREZIOSO
General Counsel

ERIC SUMMERGRAD
Deputy Solicitor

SUSAN S. McDONALD
Senior Litigation Counsel

JEFFREY T. TAO
Attorney (202) 942-0863

Securities and Exchange Commission
450 5th Street, N.W.,
Washington, D.C. 20549

[Table of Contents and Table of Authorities
Intentionally Omitted]

*Appendix D*

## INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

This brief is filed in response to the Court's request that the Securities and Exchange Commission, the agency principally responsible for administration and enforcement of the federal securities laws, file an *amicus curiae* brief addressing the Court's questions about the scope of the preemption provisions codified as Section 28(f) of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb(f), and Section 16(b) of the Securities Act of 1933, 15 U.S.C. § 78p(b), which were enacted as part of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA").

## STATEMENT OF THE CASE

1. *The Facts Alleged in the Complaints*

These consolidated class actions arise from defendant Merrill Lynch's alleged failure to provide objective research and stock recommendations to its customers, contrary to its promises to do so in exchange for the payment of annual fees and higher commissions. Both complaints rely on and incorporate the allegations in the affidavit filed by the New York Attorney General in support of his application for injunctive relief against Merrill Lynch under New York law. *See IJG* J.A. 12-14; *Dabit* J.A. 4, 43-80. The plaintiffs allege that, to promote business for its investment banking division, Merrill Lynch issued false and misleading analyst reports concerning publicly traded securities, and failed to disclose this conflict of interest between its research and investment banking divisions. *See IJG* J.A. 7-8, 11-13; *Dabit* J.A. 28.

## *Appendix D*

In *IJG*, the plaintiffs propose to represent a class of all Merrill Lynch customers who had retail brokerage accounts with Merrill Lynch and paid a commission or annual fees during the period covered by the state statute of limitations. *IJG* J.A. 15. The *IJG* plaintiffs assert common law claims for breach of contract and breach of the duty of good faith and fair dealing. *Id.* at 22. They contend that their contract claim does not depend on any allegation of misrepresentation, but alleges only that Merrill Lynch failed to deliver the unbiased research it promised, thereby breaching its contractual duty. *IJG* Br. at 41. They also assert claims under Minnesota's Consumer Fraud Act and Deceptive Trade Practices Act; in that context, they do allege that Merrill Lynch made misrepresentations about its research reports. *See IJG* J.A. 18-22.

In *Dabit*, the plaintiffs propose to represent two subclasses of Merrill Lynch employees. One subclass alleges that based on Merrill Lynch's biased research reports its members continued to hold securities in their personal portfolios that they otherwise would have sold; they seek unspecified damages for losses attributable to holding the securities. *Dabit* J.A. 25. The other proposed *Dabit* subclass consists of Merrill Lynch employees who, as a result of Merrill Lynch's biased research, lost clients and the commissions those clients would have paid in future transactions. *Id.* The *Dabit* plaintiffs assert claims for breach of fiduciary duty and breach of the covenant of good faith and fair dealing. *Id.* at 37-38.

*Appendix D*

2. *The District Court Decision*

The *IJG* plaintiffs filed their complaint in Minnesota state court; the *Dabit* plaintiffs did so in Oklahoma state court. After Merrill Lynch removed the cases to federal court pursuant to SLUSA, the Judicial Panel for Multidistrict Litigation centralized these and a number of other cases "involv[ing] common questions of fact" in the United States District Court for the Southern District of New York. *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 223 F. Supp. 2d 1388, 1389 (J.P.M.L. 2002). On April 10, 2003, the district court (Pollack, J.) dismissed the complaints in *IJG* and *Dabit*, and two other cases in which appeals were not taken, as preempted by SLUSA. *See Dabit* J.A. 213; *IJG* J.A. 34.

The district court's order did not address the specific arguments the plaintiffs made in asserting that their claims were not preempted by SLUSA. The court instead focused on the fact that the complaints referred to the same factual allegations of biased research reports relied on in the federal securities fraud actions with which they had been centralized. *Id.* For that reason, the court concluded, "[t]he claims alleged in the [two] actions fall squarely within SLUSA's ambit." *Id.*

*Appendix D*

## ARGUMENT

In requesting a brief from the Commission, the Court posed four questions concerning the scope of SLUSA. First, the Court asked whether, in requiring that a preempted action allege wrongdoing "in connection with the purchase or sale" of covered securities under SLUSA, Congress intended the "in connection with" requirement to have the same meaning as the identical term used in the antifraud provision in Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b). Second, the Court asked whether the "purchaser-seller rule of standing or otherwise enunciated in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), should be adopted for SLUSA." Third, the Court asked "[w]hether SLUSA preempts actions that could not have been brought pursuant to § 10(b) and Rule 10b-5." Finally, the Court asked whether four scenarios, based on various claims in these cases, satisfy the "in connection with" requirement.

### A. SLUSA Was Adopted to Prevent the Use of State Law Actions to Avoid the Requirements of the Federal Private Securities Litigation Reform Act.

SLUSA represented a significant change in the relationship between the federal securities laws and state law. When Congress adopted the Securities Act in 1933 and the Exchange Act in 1934, it intended to supplement rather than supplant state "blue sky" laws, many of which predated the federal statutes by more than twenty years. *See* Testimony of the U.S. Securities and Exchange Commission Concerning S. 1260, the Securities Litigation Uniform Standards Act of 1997 before the Subcommittee on Securities Committee on

Banking, Housing and Urban Affairs, 105th Cong. 2 (Oct. 29, 1997) (statement of the Commission). As originally enacted, neither statute preempted any state law and, to the contrary, specifically preserved all other remedies available under state or federal law. *Id.* at 2-3.

This was still true when, in 1995, Congress adopted the Private Securities Litigation Reform Act ("PSLRA"). That statute was enacted to filter out potential strike suits by, among other things, imposing more stringent pleading requirements and mandatory discovery stays for federal securities fraud actions. *See Spielman v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 332 F.3d 116, 122 (2d Cir. 2003).

After it enacted the PSLRA, Congress became concerned that plaintiffs were evading PSLRA requirements, particularly the heightened scienter pleading standard and discovery stay, by filing suits under state law in state courts. *See* SLUSA, Pub. L. No. 105-353, § 2(2), 112 Stat. 3227. In 1998, therefore, Congress enacted SLUSA, and stated in the legislation that it was doing so to "prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the [PSLRA]." *Id.* Sec. 2(5). *See also Green v. Ameritrade, Inc.*, 279 F.3d 590, 595 (8th Cir. 2002) (SLUSA prevents plaintiffs from evading federal protections against "abuse litigation" by filing suit in state, rather than federal courts).

*Appendix D*

SLUSA altered the federal-state relationship by largely preempting state law securities fraud class actions.[1] Section 28(f) of the Exchange Act provides that "[n]o covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging * * * [either] a misrepresentation or omission of a material fact" or "that the defendant used or employed any manipulative or deceptive device or contrivance", "in connection with the purchase or sale of a covered security."

Although the PSLRA had not imposed a heightened pleading requirement on private actions under the Securities Act and there was no perceived "flight" of private actions under the Securities Act from federal to state courts, SLUSA nevertheless also amended the Securities Act to provide, in Section 16(b), that no class action based on state law may be maintained in state or federal court by any private party alleging "an untrue statement or omission of a material fact" or "that the defendant used or employed any manipulative or deceptive device or contrivance," "in connection with the purchase or sale of a covered security."

SLUSA has been held by this Court and others to be a statute of "complete preemption," meaning that for any claim that falls within its scope only a federal claim exists and the

---

1. Two years earlier, in the National Securities Markets Improvement Act of 1996 ("NSMIA"), Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in part at 15 U.S.C. § 77r, 80a), Congress for the first time preempted some state securities regulation and divided the responsibility for securities registration and investment adviser registration between the Commission and the states.

complaint must be dismissed if the action has been brought only under state law. *See Spielman*, 332 F.3d at 123-124; *Green*, 279 F.3d at 596.

### B. The Phrase "In Connection With The Purchase Or Sale" Of Securities, as Used in SLUSA, Has The Same Broad Meaning as In Section 10(b) of the Exchange Act.

The Court's first question is whether decisions interpreting the phrase "in connection with the purchase or sale" of securities in Section 10(b) of the Exchange Act and Rule 10-5 are applicable to the interpretation of that same phrase in SLUSA's preemption provisions. The Commission recently addressed this question in an *amicus* brief filed in *Gray v. Seaboard Securities, Inc.*, No. 03-7184 (2d Cir.) (brief filed October 6, 2003) ("*Gray* Br."). As we discussed there, the phrase "in connection with the purchase or sale" found in SLUSA has been correctly construed by courts to mean the same thing as the identical phrase found in Section 10(b) of the Exchange Act. As the Court of Appeals for the Eleventh Circuit has stated:

> In enacting SLUSA, . . . Congress was not writing on a blank slate; instead, it was legislating in an area that had engendered tremendous amounts of litigation and received substantial judicial attention. In using the phrase "in connection with the purchase or sale of a covered security," Congress was not creating language from a vacuum; instead, it was using language that, at the time of SLUSA's enactment, had acquired

> settled, and widely-acknowledged meaning in the field of securities law, through years of judicial construction in the context of § 10b-5 [sic] lawsuits. Under these circumstances, we must presume that Congress intended the phrase "in connection with the purchase or sale of a covered security" to have the same meaning in SLUSA that it has in Section 10b-5 [*sic*].

*Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 292 F.3d 1334, 1342-43 (11th Cir.), *cert. denied*, 537 U.S. 950 (2002); *accord Green*, 279 F.3d at 597; *Falkowski v. Imation Corp.*, 309 F.3d 1123, 1129 (9th Cir. 2002), *opinion amended*, 320 F.3d 905 (9th Cir. 2003). Moreover, the state law cases Congress wanted to preempt in SLUSA were those that were being brought in order to avoid the PSLRA requirements that, in turn, had been enacted largely because of abusive Section 10(b) actions. Adopting for SLUSA purposes a construction of the term that is more restrictive than the definition applied under Section 10(b) would mean that litigants could continue to bring some cases under state law rather than being forced to sue under Section 10(b) and its attendant constraints.

In general, courts have recognized that the meaning of the Section 10(b) phrase "in connection with the purchase or sale of any security" is "as broad and flexible as is necessary to accomplish the statute's purpose of protecting investors." *See SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1362 (9th Cir. 1993), and cases discussed therein. This Court has long recognized that the "in connection with" requirement in Section 10(b) is satisfied when a misrepresentation is made

"in a manner reasonably calculated to influence the investing public." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (*en banc*). *Accord*, *McGann v. Ernst & Young*, 102 F.3d 390, 392-96 (9th Cir. 1996); *Britt v. Cyril Bath Co.*, 417 F.2d 433, 435-36 (6th Cir. 1969).

By its plain terms the phrase "in connection with the purchase or sale" of a security requires only that there be a nexus or relationship between the fraud and a securities transaction. *See Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971) (paraphrasing "in connection with" as "touching"); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977) (quoting "touching" language from *Bankers Life* with approval); *SEC v. Clark*, 915 F.2d 439, 449 (9th Cir. 1990) ("some nexus"); *Abrams v. Oppenheimer Gov't Sec., Inc.*, 737 F.2d 582, 593 (7th Cir. 1984) ("some nexus but not necessarily a direct and close relationship"); *Brown v. Ivie*, 661 F.2d 62, 65 (5th Cir. 1981) ("a nexus"). The necessary connection therefore exists when, among other situations, "the proscribed conduct and the sale are part of the same fraudulent scheme," *Alley v. Miramon*, 614 F.2d 1372, 1378 n. 1 1 (5th Cir. 1980) (Wisdom, J.), such as when the fraud and the sale of securities "coincide," *SEC v. Zandford*, 535 U.S. 813, 822 (2002).

We believe that under these principles, the "in connection with the purchase or sale of" securities requirement is satisfied when a broker-dealer makes a misrepresentation or omission to a customer that relates to the customer's brokerage account regardless of whether the deception coincides with, or could be expected to influence, a securities transaction. This is so because any misrepresentation or

omission relating to an account should ordinarily be regarded as inherently "in connection with the purchase or sale of any security." The very purpose of a brokerage account is to buy and sell securities. Thus, any deception that could affect the decision of the customer to open a brokerage account, and to do so on the terms specified in the account agreement, closely touches on securities transactions. *See Gray* Br. at 12 n.9; *see also* SEC Amicus Br. at 13-14, filed in 1996 in *Bissell v. Merrill Lynch & Co.*, 157 F.3d 138 (2d Cir. 1998).

There is no merit to the plaintiffs' claim here (*see IJG* Br. at 28) that only misrepresentations about particular securities bought or sold by a plaintiff, or that induce a particular purchase or sale, meet the "in connection with" requirement, while misrepresentations about the general character of research provided by a brokerage firm or that affect the commissions charged on securities trades are excluded. That argument no longer can be made after the Supreme Court's decision in *Zandford*, 535 U.S. at 821, which expressly rejected the contention that fraud must pertain to the value of a security or "manipulation of a particular security" in order to meet the "in connection with" requirement. This Court had earlier rejected such a limitation on the scope of the "in connection with" language when it held in *Press v. Chemical Investment Services Corp.*, 166 F.3d 529, 537 (2d Cir. 1999), that the statutory language encompassed an alleged misrepresentation about when the proceeds of a securities sale would be available to the customer.

*Appendix D*

**C. Three Of the Four Situations Identified By The Court Involve Misrepresentations "In Connection With The Purchase Or Sale" Of Securities.**

Applying the foregoing view of the "in connection with" language in SLUSA, we believe that the first three scenarios identified by the Court in its request satisfy the "in connection with" requirement, while the fourth scenario does not. The Court asked:

> Where a brokerage allegedly issued intentionally false and biased research reports to garner investment banking business, whether the following state law claims arising from that activity meet SLUSA's 'in connection with' requirement:
>
> > (a) claims brought by the brokerage's clients for annual flat fees paid to the brokerage for unbiased investment research, which fees are not triggered by any actual purchases or sales of securities;
> >
> > (b) claims brought by the brokerage's clients for commissions fees paid to the brokerage for investing in securities recommended by the biased research;
> >
> > (c) claims brought by the brokerage's broker-employees for investment losses suffered in retaining securities as a result of

the brokerage's falsely touting the securities' values; and

(d) claims brought by the brokerage's broker-employees for the loss of future commissions to be paid by their clients who left the brokerage as a result of the biased research?

As to hypothetical (a), it is reasonable to expect that Merrill Lynch customers would be influenced, both in deciding to open accounts at the firm and later in making securities transactions, by the firm's false statements that its recommendations were objective. The very reason that a customer decides to pay additional fees in exchange for objective stock recommendations is to obtain information on which to decide whether to buy and sell securities. Even if a customer does not in fact later engage in securities transactions in the account, the deception in causing the account to be opened is so inherently related to securities transactions that it satisfies the "in connection with the purchase or sale" requirement in SLUSA. *See, e.g., McCullagh v. Merrill Lynch & Co.*, 01-Civ-7322-DAB, 2002 WL 362774, at *4 (S.D.N.Y. Mar. 6, 2002) (similar allegations of biased research satisfy the "in connection with" language of SLUSA because the alleged misrepresentation concerns "the quality of investment advice"); cf. *Rowinski v. Salomon Smith Barney, Inc.*, No. 3:02cv2014, 2003 WL 22740976, at *3 (M.D. Pa. Nov. 20, 2003) ("plaintiff would not be concerned with the accuracy of SSB's analyst reports unless he intended to, and did, in fact, rely on them in deciding to purchase or sell stock").

*Appendix D*

An even closer connection exists between the alleged fraud and securities transactions under hypothetical (b). Under that hypothetical the fees paid as a result of the deceptive research claims are triggered if and when the customer makes an actual purchase or sale of securities. It seems apparent that a fraudulently induced fee that is paid as part of a securities transaction is a fraud "in connection with" that transaction. *See Rowinski*, 2003 WL 22740976, at * 3 (concluding on similar facts that alleged fraud was "in connection with the purchase or sale" of securities in part because "[a] commission is earned by SSB only when a customer purchases or sells securities").

The Commission also believes that hypothetical (c) would come within the "in connection with the purchase or sale" language in SLUSA. Even though the first proposed *Dabit* subclass consists only of Merrill Lynch employees, their claim is no different than that of any investor who continued to hold securities based on misrepresentations – their status as employees is irrelevant.

The final claims, described in hypothetical (d), fall outside the "in connection with the purchase or sale" language, and therefore outside SLUSA's preemption provisions. The premise of this hypothetical is that the customers to which the misrepresentations were made stopped doing business with the broker after they learned of the biased research. Because the customers were made aware of the falseness of the misrepresentations, the continuing effect of the misrepresentations necessarily ended. The broker-employees' claims, therefore, are not based on misrepresentations that could be part of a fraudulent scheme

in which the misrepresentations played a part; they did not coincide with, nor might they have influenced, any possible purchase or sale of securities. To the contrary, the employees' claims necessarily depend on the fact that the former customers have learned of the misrepresentations and will not in the future engage in securities transactions through Merrill Lynch, where the plaintiffs are employed. The claims in this hypothetical simply have no factual or logical link to the alleged deception.

That the first three hypotheticals satisfy the "in connection with" requirement does not, however, mean that private plaintiffs making these claims can sue under Section 10(b) and Rule 10b-5. A private plaintiff suing under these provisions only has standing to sue if they allege that they either purchased or sold securities as a result of the alleged falsehood. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) ("*Blue Chip*"). Thus, to the extent plaintiffs alleging claims under hypotheticals (a) and (c) did not buy or sell securities as a result of the alleged fraud, they could not sue under Section 10(b) and Rule 10b-5. This does not mean, however, that the claims do not satisfy the "in connection with" requirement. As this Court has recently held, it is error to "conflate the issue of standing" under *Blue Chip* "with the question of whether the 'in connection with' requirement has been met," since these are "two distinct inquiries." *Ontario Public Serv. Employees Union Pension Trust Fund v. Nortel Networks Corp.*, 2004 WL 1110496, *6, 379 F.3d 27 (2d Cir. May 19, 2004).

*Appendix D*

**D. SLUSA Applies to Preempt State Law Actions Even if the Actions Do Not Meet the Purchaser/Seller Standing Requirement of *Blue Chip*.**

The next question is whether the purchaser-seller rule enunciated in *Blue Chip* (originally articulated in this Court's decision in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952)), should be adopted under SLUSA. Some state law actions for securities fraud do not contain this requirement. *See, e.g., Small v. Fritz Cos.*, 65 P.3d 1255, 1260-1261, 1263 (Cal. 2003). If SLUSA contains a purchaser/seller limitation, those state law actions would not be preempted.

The courts that have considered the issue have held that SLUSA does not preempt actions that do not meet the purchaser/seller requirement. They reason that the purchaser/seller limitation under Section 10(b) is based on a construction of the phrase "in connection with the purchase or sale" of securities, and that the use of the same phrase in SLUSA carries with it the same construction. For example, in *Riley*, 292 F.3d at 1342-43 the Eleventh Circuit held:

> In using the phrase "in connection with the purchase or sale of a covered security," Congress was not creating language from a vacuum; instead, it was using language that, at the time of SLUSA's enactment, had acquired settled, and widely-acknowledged, meaning in the field of securities law, through years of judicial construction in the context of § 10b-5 lawsuits. Under these circumstances, we must presume that Congress intended the phrase "in connection with the

> purchase or sale of a covered security" to have the same meaning in SLUSA that it has in § 10b-5.

*Id.* (emphasis in original). *Accord*, *Green*, 279 F.3d at 598; *Gutierrez v. Deloitte & Touche, L.L.P.*, 147 F. Supp. 2d 584, 595 (W.D. Tex. 2001).[2]

These decisions misapprehend the relationship between the purchaser/seller requirement and the "in connection with" element in Section 10(b). The *Blue Chip* Court began its analysis by noting that when this Court articulated the purchaser/seller limitation in *Birnbaum*, it relied on the facts that

> both § 10(b) and Rule 10b-5 proscribed only fraud "in connection with the purchase or sale" of securities, and * * * the history of § 10(b) revealed no congressional intention to extend a private civil remedy for money damages to other than defrauded purchasers or sellers of securities,

---

2. *See also Gordon v. Buntrock*, 2000 WL 556763, at *4 (N.D. Ill. Apr. 28, 2000) (Mem. Op.); *Simon v. Internet Wire, Inc.*, 2001 U.S. Dist. LEXIS 4086, Fed. Sec. L. Rep. (CCH) ¶ 91,408 (C.D. Cal. Apr. 3, 2001); *Burns v. Prudential Sec.*, 116 F. Supp. 2d 917, 922-23 (N.D. Ohio 2000); *Shaev v. Claflin*, 2001 U.S. Dist. LEXIS 6677, Fed. Sec. L. Rep. (CCH) ¶ 91,452 (N.D. Cal. May 17, 2001); *Shaw v. Charles Schwab & Co., Inc.*, 128 F. Supp. 2d 1270, 1272 (C.D. Cal. 2001); *Hines v. ESC Strategic Funds, Inc.*, 1999 U.S. Dist. LEXIS 15790, No. 3:99-0530, 1999 WL 1705503, at *6 (M.D. Tenn. Sept. 17, 1999); *Lalondriz v. USA Networks*, 54 F. Supp. 2d 352, 353-54 (S.D.N.Y.), *adhered to on reconsideration by* 68 F. Supp. 2d 285, 286 (S.D.N.Y. 1999).

> in contrast to the express civil remedy provided by § 16(b) of the 1934 Act

421 U.S. at 731, citing *Birnbaum*, 193 F. 2d at 463-464. The Supreme Court stated that "the wording of § 10 (b), making fraud in connection with the purchase or sale of a security a violation of the Act, is surely badly strained when construed to provide a cause of action, not to purchasers and sellers of securities, but to the world at large." 421 U.S. at 733 n.5. The Court also noted that Congress twice rejected Commission proposals to add language to Section 10(b) referring to "any attempt to purchase or sell, any security," *id.* at 732. The Court concluded (*id.* at 733):

> The longstanding acceptance by the courts, coupled with Congress' failure to reject *Birnbaum*'s reasonable interpretation of the wording of 10 (b), wording which is directed toward injury suffered "in connection with the purchase or sale" of securities, argues significantly in favor of acceptance of the *Birnbaum* rule by this Court. *Blau v. Lehman*, 368 U.S. 403, 413 (1962).[3]

---

3. The Court also noted that other portions of the securities laws suggested a purchaser/seller requirement. In contrast to Section 10(b), Section 17(a) applies to "offers" to sell securities, showing that "[w]hen Congress wished to provide a remedy to those who neither purchase nor sell securities, it had little trouble in doing so expressly." *Id.* at 734. It also observed that the requirement in Section 28(a) of the Exchange Act, which requires that a plaintiff prove "actual damages," would counsel against allowing suits where the

(Cont'd)

The *Blue Chip* Court went on, however, to state: "[h]aving said all this, we would by no means be understood as suggesting that we are able to divine from the language of § 10(b) the express 'intent of Congress' as to the contours of a private cause of action under Rule 10b-5." 421 U.S. at 738. The Supreme Court held, rather, that in construing a judicially inferred private right of action, it would be

> proper that we consider, in addition to the factors already discussed, what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance.

*Id.* at 737. Turning to these policy considerations, the Court stated (*id.* at 743, emphasis added) that "[t]he *Birnbaum* rule undoubtedly excludes plaintiffs who have in fact been damaged by *violations* of Rule 10b-5, and to that extent it is undesirable." In concluded, however, that this disadvantage was outweighed by the benefits of the rule in the elimination of cases involving great difficulties of proof and potential for vexatiousness (*id.* at 739-744). In short, although the Court concluded that the purchaser/seller requirement was consonant with the statutory language and structure,

---

(Cont'd)

alleged injury "largely conjectural and speculative." *Id.* at 734-735. And it noted that the express non-derivative remedies in the Securities Act (Sections 11 (a) and 12) and Exchange Act (Sections 9 and 18) all contain a requirement that the plaintiff purchase or sell securities. *Id.* at 736.

it indicated that if there were no net policy advantage to the purchaser/seller rule, it would not have endorsed it. *See* 421 U.S. at 738-39. Yet the policy concerns that led to the adoption of the rule under Section 10(b) do not appear to-apply under SLUSA.[4] As applied under Rule 10b-5, the purchaser/seller rule serves to eliminate lawsuits that involve difficult issues of proof and are vexatious. Were the same rule to apply under SLUSA it would have the opposite effect, in that it would allow lawsuits with precisely these vexatious characteristics to go forward. In addition, adopting a purchaser/seller rule would make preemption turn on whether a state had a purchaser/seller requirement for its securities fraud actions. Rather than enforcing a uniform national standard, as SLUSA was intended to do, the application of the Act would turn on what standing rule a state happened to recognize.

Some courts that have applied a purchaser/seller limitation under SLUSA have nonetheless done so in part based on the view that to do so is consonant with one policy reason for the *Blue Chip* decision. The *Blue Chip* Court said that the disadvantage of denying relief to a victim of securities fraud "is attenuated to the extent that remedies are available to nonpurchasers and nonsellers under state law." *Id.* at 738 n.9. These courts have reasoned that to apply SLUSA to preempt such state law suits would undercut this rationale.

---

4. The Commission takes no position on whether the Court could adopt a purchaser/seller limitation under SLUSA as a matter of policy. In *Blue Chip*, the Court held that it could consider policy because it was construing the parameters of an implied cause of action that had been judicially created in the first place. *See* 421 U.S. at 737.

*See Riley*, 292 F.3d at 1344-1345; *Green*, 279 F.3d at 598; *Guttierez*, 147 F. Supp. 2d at 595. It is hardly clear, however, that the Congress that adopted SLUSA, which radically altered the relationship between federal and state law concerning securities fraud, entertained a similarly benign view of state law actions. To believe that would require a conclusion that while Congress saw fit under SLUSA to preempt most state law causes of action as a vexatious end-run around federal limitations on private securities law suits, it nevertheless exempted from preemption one state law cause of action the *Blue Chip* Court saw as a particularly vexatious form of litigation.

Adoption of the purchaser/seller rule for SLUSA poses other potentially serious problems. If the purchaser/seller rule is incorporated into the "in connection with" language, that same limitation arguably would apply to the Commission and the United States in civil and criminal enforcement cases under Section 10(b), since those also must meet that statutory element. Yet the Court has been explicit, in *Blue Chip* and afterwards, that the purchaser/seller requirement applies only to private securities fraud actions seeking damages, and not to government enforcement actions. *See Blue Chip*, 421 U.S. at 751 n.14 ("the purchaser-seller rule imposes no limitation on the standing of the SEC to bring actions for injunctive relief under § 10(b) and Rule 10b-5"); *United States v. Naftalin*, 441 U.S. 768, 774 n.6 (1979) (*Blue Chip* is "inapplicable" to a criminal prosecution).

Application of a purchaser/seller limitation to government actions could have a damaging effect on the enforcement of the securities laws in cases where it could

not be shown that some investor purchased or sold securities. Hypothetical (c), discussed above, presents such a scenario. For this reason, as noted, this Court has long required, to meet the "in connection with" requirement, only that it be shown that a fraudulent statement was made "in a manner *reasonably calculated* to influence the investing public * * *." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (emphasis added).

Finally, the *Blue Chip* Court recognized that even in a private action, a violation of Section 10(b) could exist without a purchase or sale of securities. The Court stated that "[t]he *Birnbaum* rule undoubtedly excludes plaintiffs who have in fact been damaged by *violations of Rule 10b-5*, and to that extent it is undesirable." 421 U.S. at 743 (emphasis added). If, absent a purchase or sale, the "in connection with" requirement was not met, the Court could not have believed that violations of Section 10(b) could have occurred, since an essential element of Section 10(b) would be absent.

We note, finally, that were SLUSA to apply only where there is an allegation of a purchase or sale of securities, the preemption of class actions would become a complex question. Even if the action only alleges that it is brought on behalf of persons who held securities during the class period, some of those persons will in fact have bought or sold the securities during the period. Would the entire class action be excluded from SLUSA preemption because there is no allegation of a purchase or sale, or will the court have to go behind the pleadings to ascertain if any of the class members in fact have purchaser/seller standing? This potential problem does not exist under the construction of SLUSA we propose here.

**E. SLUSA Preempts State Law Actions Even Under Certain Circumstances Where They Could Not Be Brought Under Section 10(b) And Rule 10b-5.**

The Court also asks "[w]hether SLUSA preempts actions that could not have been brought pursuant to § 10(b) and Rule 10b-5." This question is broad because there are a number of reasons why an action might not be sustainable under Section 10(b). One would be that there is no misrepresentation or other deception. The clear language of SLUSA, however, requires that the action allege a misrepresentation or misleading omission or other deception. Thus, the Commission does not believe the defendants are correct that a pure breach-of contract claim – with no allegation of misrepresentation - comes within the terms of the preemption provisions. It seems clear from the face of the statute that claims containing *no* allegations of misrepresentation, untrue statements or any other form of fraud, such as claims alleging only a breach of contract or breach of fiduciary duty – are not preempted by SLUSA.

Another reason a Section 10(b) claim might fail would be because the fraud was not "in connection with the purchase or sale of securities." Since, however, as discussed above, the "in connection with" requirement in SLUSA is co-extensive with that in Section 10(b), a claim that failed for this reason also would fail to meet the "in connection with" requirement in SLUSA, and would not be preempted. A private Rule 10b-5 action might also fail because the plaintiff lacks *Blue Chip* standing; yet because SLUSA contains no such limitation, that fact would not preclude SLUSA preemption.

*Appendix D*

The plaintiffs take the position (*see IJG* Br. at 19-20, 33) that SLUSA preempts only "traditional" or "typical" securities fraud, and, thus, that SLUSA does not preempt claims that would not state a claim under Section 10(b) for lack of an allegation of scienter (that is, that the deception was either knowing or reckless), which is an element of an action under Section 10(b) of the Exchange Act and Rule 10b-5. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976); *see also Aaron v. SEC*, 446 U.S. 680, 696 (1980). *See Dabit* Reply Br. at 4-5 (relying on *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 110 (2d Cir. 2001)).

We believe, however, that the statute's language makes clear that SLUSA preemption does not require an allegation of scienter.[5] Section 28(f) of the Exchange Act preempts allegations that the defendant used a "manipulative or

5. There is scant judicial authority on the issue. The only federal court of appeals to address the issue has held, after noting that Section 16(b) of the Securities Act preempts non-scienter-based causes of action, that scienter is not required for SLUSA preemption. *See Riley v. Merrill Lynch Pierce, Fenner & Smith. Inc.*, 292 F.3d 1334, 1345-1346 (11th Cir.), *cert. denied,* 537 U.S. 950 (2002); *see also In re Worldcom*, 263 F. Supp. 2d 745 (S.D.N.Y. 2003) (similar). Some district courts, with little analysis, have concluded that SLUSA preempts only allegations of fraud with scienter, apparently accepting the view that Congress intended to reach only claims analogous to Section 10(b) claims. *See,, Green v. Ameritrade. Inc.*, 120 F. Supp. 2d 795, 798 (D. Neb. 2000), *aff'd on other grounds*, 279 F.3d 590 (8th Cir. 2002); *Burns v. Prudential Sec.*, 116 F. Supp. 2d 917, 923-24 (N.D. Oh. 2000).

deceptive device or contrivance" or made a "misrepresentation or omission of a material fact," "in connection with the purchase or sale of a covered security." Section 16(b) of the Securities Act replaces the first clause with a requirement that the defendant made "an untrue statement or omission of a material fact" but otherwise is identical to Section 28(f).

These terms are drawn from essentially identical language contained in Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act. The Supreme Court has held that the term "manipulative or deceptive device or contrivance" requires scienter. *See Ernst & Ernst v. Hochfelder*, 425 U.S. at 199 ("the words 'manipulative,' 'device,' and 'contrivance' [terms used in Section 10(b) of the Exchange Act] [are] terms that make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence"). On the other hand, the term "untrue statement or omission to state a material fact" does not. *See Aaron*, 446 U.S. at 696 (holding that "untrue statement" or "omission of a material fact" language is "devoid of any suggestion whatsoever of a scienter requirement"). As to the term, "misrepresentation * * * of a material fact," the *Aaron* Court noted that in *Hochfelder*, it

> pointed out that the similar language of Rule 10b-5(b) "could be read as proscribing . . . any type of material misstatement or omission . . . that has the effect of defrauding investors, whether the wrongdoing was intentional or not."

*Id.*, quoting *Hochfelder*, 425 U.S. at 212.[6] Although Section 28(f) uses the term "misrepresentation" rather than "misstatement" (the word used in Rule 10b-5(b)), we do not think the terms are significantly different. The common understanding of the term "misrepresentation" is that it does not require intent. The common law recognizes, for example, that actionable "misrepresentation" may be the product of negligence. *See, e.g.*, Restatement (Second) of Torts § 304 (2004). In short, since SLUSA applies where any of these forms of deception is alleged, the language of SLUSA does not on its face require that the plaintiff's allegations state a scienter-based claim, as required under Rule 10b-5.

The imposition of a scienter requirement would also be inconsistent with SLUSA's principal purpose. In adopting SLUSA, Congress stated, as part of the findings in the legislation itself, that

> in order to prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the Private Securities Litigation Reform Act of 1995, it is appropriate to enact national standards for securities class action lawsuits involving nationally traded securities, while preserving the appropriate enforcement powers of State securities regulators and not changing the current treatment of individual lawsuits.

---

6. Although the *Hochfelder* Court conceded that the language in Rule 10b-5 could support liability for negligence, Rule 10b-5 requires a showing of scienter because it is constrained by the narrower language of Section 10(b). *See* 425 U.S. at 214.

SLUSA, Pub. L. No. 105-353, § 2(5), 112 Stat. 3227. While part of Congress's concern was the procedural constraints on class action litigation, another concern was compelling compliance with the PSLRA's heightened scienter pleading standard, which requires plaintiffs in Rule 10b-5 cases to allege scienter with greater specificity than many courts had previously required. *See* 15 U.S.C 78u-4(b). To the extent that migration toward state courts had been fueled by this requirement, it would have been because plaintiffs found it difficult, after the PSLRA, to make an adequate claim of scienter in Rule 10b-5 cases. If it were to be held that SLUSA does not apply to a case which cannot, for lack of an allegation of scienter, be brought under Rule 10b-5, this objective of SLUSA would be largely undercut. SLUSA could not compel compliance with the PSLRA's scienter pleading standard, since it simply would not apply to any class action complaint that could not comply with the PSLRA standard. Congress could not have intended such a self-defeating result.[7]

---

7. Nothing in the language of SLUSA suggests that any of the other requirements of a private Rule 10b-5 action - such as statute of limitations, reliance, loss causation - must be met before SLUSA preemption will apply.

*Appendix D*

## CONCLUSION

For the foregoing reasons, the Court should rule in accordance with the positions urged in this brief.

Respectfully submitted,

GIOVANNI P. PREZIOSO
General Counsel

s/ Eric Summergrad
ERIC SUMMERGRAD
Deputy Solicitor

s/ Susan S. McDonald
SUSAN S. McDONALD
Senior Litigation Counsel

s/ Jeffrey T. Tao
JEFFREY T. TAO
Attorney (202) 942-0863

Securities and Exchange Commission
450 5th Street, N.W.,
Washington, D.C. 20549

June 2004